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TAX CONVENTION WITH THE FEDERAL REPUBLIC OF GERMANY

REPORT

OF THE

COMMITTEE ON FOREIGN RELATIONS UNITED STATES SENATE

ON

TREATY DOCUMENT 101-10, 101ST CONGRESS, 2D SESSION, TAX CONVENTION WITH THE FEDERAL REPUBLIC OF GERMANY

July 27 (legislative day, July 10), 1990.—Ordered to be printed

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Mr. Pell, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 101-10, 101st Congress, 2d Session]

The Committee on Foreign Relations, to which was referred the Convention between the United States of America and the Federal Republic of Germany for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital and to certain other taxes, together with a related protocol, signed at Bonn on August 29, 1989, having considered the same, reports favorably thereon with an understanding and recommends that the Senate give its advice and consent to ratification thereof.

I. Purpose

The principal purposes of the proposed income tax treaty between the United States and the Federal Republic of Germany ("Germany") are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country, and to prevent avoidance or evasion of income taxes of the two countries. The proposed treaty is intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

II. Background

The proposed treaty and proposed protocol were both signed on August 29, 1989, and amplified by diplomatic notes signed the same day and on November 3, 1989. The proposed treaty would replace the existing income tax treaty between the two countries that was signed in 1954 and amended by a protocol signed in 1965.

The treaty was transmitted to the Senate for advice and consent to its ratification on February 5, 1990. The Senate Committee on Foreign Relations held a public hearing on the proposed treaty on June 14, 1990.

III. SUMMARY

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty ("U.S. model treaty"), and the 1977 model income tax treaty of the Organization of Economic Cooperation and Development ("OECD model treaty"). However, there are certain substantive deviations from those documents. Among other things, the proposed treaty includes a number of provisions to accommodate aspects of the Tax Reform Act of 1986.

As in other U.S. tax treaties, the objectives of the treaty are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard treaty provisions that neither country will tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 14). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 14, 15, and 17). The proposed treaty provides that dividends and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10 and 13). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10, 11, and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit, or, in the case where Germany is the country of residence, allowing in some cases an exemption of U.S. source income from German tax (Article 23).

The protocol contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Paragraph 1). In addition, the protocol contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries (Paragraph 1); that is, the treaty will only be applied to the benefit of taxpayers.

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. model treaty. It also differs in significant respects from the present treaty with Germany. (The present treaty predates the 1981 U.S. model treaty.) Some of these differences are as follows:

(1) The U.S. excise tax on insurance premiums paid to a foreign insurer is generally covered; that is, it is treated as a tax that may be eliminated by the treaty. This is a departure from the present treaty and other older U.S. tax treaties, although similar coverage appears in some more recent treaties, such as the present treaties with France and Hungary. The excise tax on premiums paid to foreign insurers is covered under the U.S. model treaty.

(2) Like the present treaty, but unlike the U.S. model treaty, the proposed treaty does not cover the U.S. excise taxes with respect to private foundations.

(3) By contrast with the present treaty, the proposed treaty introduces rules for determining when a person is a resident of either the United States or Germany, and hence entitled to benefits under the treaty. The proposed treaty, like the model, provides tie-breaker rules for determining the residence for treaty purposes of "dual residents," or persons who, but for the tie-breaker rules, would have residence status in each of the treaty countries. These rules differ in some respects from the rules in the U.S. model treaty. For example, under the treaty Germany need not treat U.S. citizens or green card holders as U.S. residents unless they have a substantial presence, a permanent home, or an habitual abode in the United States. The U.S. model, by contrast, provides for the other country to reduce taxes on all U.S. citizens, regardless of where they reside. The United States has frequently been unable to negotiate coverage for nonresident citizens in its income tax treaties. Exceptions include treaties with Cyprus, Malta, Hungary, New Zealand, and Sweden. The proposed treaty, unlike the U.S. model, does not treat a dual resident company as a resident of the country under whose laws it was created. Under the proposed treaty, any dual resident other than an individual will be treated as a resident of one or the other country only if the competent authorities can agree; if not, the proposed treaty (unlike the U.S. model) expressly provides that the person shall be treated as a resident of neither country for purposes of enjoying treaty benefits, and hence is entitled to no treaty benefits.

(4) The proposed treaty defines a permanent establishment more nearly in conformity with the U.S. model than does the present treaty. The proposed treaty adds a model treaty clause not contained in the present treaty excluding from the definition of a permanent establishment the maintenance of a fixed place of business solely for the purposes of purchasing goods or merchandise, or of collecting information, for the enterprise. The proposed treaty also adds language identical to the OECD model language, and similar to the U.S. model language, affirming that any combination of activities which singly do not constitute a permanent establishment will not together constitute a permanent establishment if their combination results in overall activity of a preparatory or auxiliary character.

(5) The proposed treaty does not contain the U.S. model treaty provision under which investors in real property in the country not of their residence, and who make an election to be taxed on those investments on a net basis, are bound by that election for all subse-

quent years unless the countries agree to allow the taxpayer to terminate it. Instead, the making of the election is controlled by internal law. Although current U.S. law and current German law independently provide for elective net basis taxation, the making of a second election under internal U.S. law is restricted once a first election has been revoked. By contrast, the present treaty provides that a resident of Germany may make the net basis election for any taxable year, potentially allowing German investors unintended tax planning opportunities.

(6) The business profits article of the proposed treaty omits the force of attraction rules contained in the present treaty and the Code, providing instead that the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment. This is consistent with the U.S. model treaty.

(7) The proposed protocol modifies the Internal Revenue Code rule under which, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, and the property is disposed of within 10 years after the cessation, the determination of whether any income or gain attributable to the disposition of the property is taxable on a net basis must be made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a trade or business in the United States, and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year for which the income or gain is taken into account. Under the proposed protocol, the gain of a German resident so taxable by the United States is limited to the gain that accrued during the time that the property formed part of the business property of a permanent establishment or fixed base in the United States (the same rule applies to German tax on a U.S. resident in the reverse situation). In addition, such a tax on residents of the other country can be imposed only upon realization and recognition of gain within 10 years of the date on which the property ceases to be part of the business property of the permanent establishment or fixed base, or such shorter period provided by the laws of *either* country. Thus, if Germany provides by internal law that such a tax cannot be imposed on gain realized by a foreign person in this situation if the gain is realized after the property ceases to be part of its German business, then the U.S. tax will not apply to a German resident. Currently, German internal law does allow such a tax to be imposed without a time limit. Therefore, taxes currently imposed under German law are limited by the provision.

(8) The proposed treaty, like the present and model treaties, provides that profits of an enterprise of one treaty country from the operation of ships or aircraft in international traffic are taxable only in that country. However, unlike the model treaty, the proposed treaty does not include bareboat leasing profits in the category of profits to which this rule applies. Instead, they are covered by the business profits article. Like the model treaty and unlike the present treaty, the proposed treaty provides that profits of a treaty-country enterprise from the use or rental of containers and related

equipment used in international traffic shall be taxable only in that country.

(9) The associated enterprise article of the proposed treaty, and the related paragraph of the proposed protocol, incorporate the general principles of section 482 of the Code. They also conform more closely than does the present treaty to the corresponding article in the U.S. model. In particular, the proposed treaty contains a "correlative adjustment" clause, not found in the present treaty. Under the present treaty, each country may tax an enterprise resident in that country on profits that were, by virtue of its participation in the management or the financial structure of an enterprise of the other contracting State, reduced by non-arm's-length conditions agreed to or imposed upon the second enterprise. The proposed treaty and protocol contain broader language, similar to the U.S. model, expressly permitting the use of internal law standards such as section 482. It further provides that either treaty country must correlatively adjust any tax liability it previously imposed on an enterprise for profits reallocated to an associated enterprise by the other treaty country, if the first country agrees with the substance of the second country's adjustment. The corresponding U.S. model language is slightly different in that it does not condition the making of the correlative adjustment on the first country's *agreement* to the original adjustment made by the other country.

(10) Under the proposed treaty, direct investment dividends (i.e., dividends paid to companies resident in the other country that own directly at least 10 percent of the voting shares of the payor) will generally be taxable by the source country, after the treaty is fully phased in, at a rate no greater than 5 percent. Portfolio investment dividends (i.e., those paid to companies owning less than a 10 percent voting share interest in the payor, or to noncorporate residents of the other country) are generally taxable by the source country at a rate no greater than 15 percent; however, U.S. residents who receive dividends from a company resident in Germany may receive a further relief from German tax equal to 5 percent of the gross amount of the dividend. (Different rules, discussed below, are provided for dividends from a regulated investment company, real estate investment trust, or German investment trust (Kapitalanlagegesellschaft).)

This further relief provision applicable to U.S. individual investors and corporate portfolio investors relates to Germany's introduction in 1977 of an imputation system that integrates in part the corporate income tax with the individual income tax. Under this system, earnings distributed by German resident companies as dividends are subject to a lower corporate income tax rate than are retained earnings. Currently, the tax on retained earnings is 50 percent, and the corporate-level tax on distributed earnings is 36 percent. Further, German resident shareholders subject to full tax liability in Germany on dividends from German resident companies receive an imputation credit for the remaining corporate-level tax burden. The credit is either applied against the shareholder's German income tax liability or, if the credit exceeds the liability, the excess is refunded to the shareholder. In the absence of a tax treaty, nonresidents of Germany do not receive the imputation credit.

Under the proposed treaty, U.S. portfolio investors in German resident companies generally will be entitled to a reduction in the 15 percent treaty-reduced German tax equal to an additional 5 percent of gross dividends beneficially owned. For U.S. tax purposes, the recipient is treated as having received a dividend approximately equal to an amount 85 percent of which would equal 90 percent of the gross dividend actually paid. The recipient is further treated as having paid creditable foreign income tax equal to 15 percent of that deemed dividend amount. Arithmetically, the U.S. shareholder receives the same U.S. tax treatment as if he or she had received a refund (and an income gross-up) for a corporate level tax equal to 5.88 percent of the cash dividend, and had in addition paid a withholding tax equal to 15 percent of the grossed up dividend. This could be less beneficial for the U.S. person than the U.S. treatment that might be provided under a treaty if he or she had been treated, for German purposes, like a German resident shareholder.

Absent the treaty, dividends paid to U.S. residents by German companies would be subject under present German tax rules to a withholding tax at a rate of 25 percent, and dividends paid to German residents by U.S. companies would be subject under internal U.S. tax rules to a withholding tax at a rate of 30 percent, rather than the 5 and 15 percent rates prescribed. Under the present treaty, any dividends paid by companies resident in either country to residents of the other could be taxed by either source country at a rate of up to 15 percent.

The U.S. income tax treaties with the United Kingdom and France also provide certain U.S. resident shareholders a benefit based on the use by those countries of an imputation credit as a means for integrating the corporate and individual tax systems. The Committee understands that the proposed treaty clause providing integration-related relief was the first negotiated and signed by Germany. To date, it is understood that Germany has signed but not yet ratified one other similar treaty clause with Switzerland.

(11) The proposed treaty retains the present treaty's withholding rate of 15 percent on dividends if those dividends are paid by a regulated investment company (RIC) or a German investment trust, regardless of any imputation benefits provided to other dividends, and regardless of whether the RIC or German investment trust dividends are paid to a direct or portfolio investor. The proposed treaty eliminates the present treaty's reduction of U.S. withholding tax on dividends if those dividends are paid by a real estate investment trust (REIT), unless the dividend is beneficially owned by an individual German resident holding a less than 10 percent interest in the REIT. Germany will avoid double taxation on all dividends from RICs and other deductible dividends using the credit method, rather than the exemption method. The Senate recently gave advice and consent to protocols with France and Belgium on the understanding that provisions be negotiated with those countries permitting withholding rates on RIC and REIT dividends higher than the rates provided for in general by the U.S. treaties with those countries, and the proposed treaty provisions address the concerns to which those understandings were addressed.

(12) Unlike the present treaty as interpreted by the Treasury Department, the proposed treaty expressly permits the United States

to impose the branch profits tax. The present treaty also expressly prevents imposition of any other form of second-level withholding tax. The U.S. branch profits tax may be imposed at a rate not exceeding 5 percent under the proposed treaty.

(13) Although the proposed treaty, like the present treaty, the U.S. model, and several U.S. treaties, generally provides for absence of source country taxation on interest, the proposed treaty provides that income from any arrangement, including debt obligations, carrying the right to participate in profits and deductible by the payor may be taxed in the source country according to its internal laws. Thus, for example, the country of source could withhold tax on deductible interest paid under an "equity kicker" loan, at rates not limited by the treaty. There is no similar provision in the present treaties or the U.S. or OECD models.

(14) Both the U.S. model treaty and the proposed treaty provide for source country taxation of capital gains from the disposition of real property regardless of whether the taxpayer is engaged in a trade or business in the source country. The proposed treaty expands the present treaty (and U.S. model) definition of real property for these purposes to encompass "U.S. real property interests." This safeguards U.S. tax under the Foreign Investment in Real Property Tax Act of 1980 which applies to dispositions of U.S. real property interests by nonresident aliens and foreign corporations.

(15) The proposed treaty permits Germany to impose its statutory tax on gains from the disposition, by an expatriate resident in the United States, of stock in a German resident company if the U.S. resident was a substantial shareholder in the German company, and disposed of the stock within 10 years of giving up German residence. The gain taxable by Germany under this treaty provision is limited to that resulting from appreciation in the stock while the person was a German resident. The treaty gives the United States reciprocal taxation rights in this respect, although internal U.S. tax law would generally impose tax in this situation, only in a limited class of cases involving tax avoidance.

(16) The proposed treaty generally conforms to the U.S. model treaty the provisions relating to independent personal services. Under the present treaty independent personal services generally can be taxed in the country where the services are performed, unless the income is earned under contract with a resident of the other country and is not borne by a permanent establishment in the source country, and the person earning the income is present in the source country less than 184 days during a taxable year. Under the proposed treaty, like the model treaty, independent personal services performed by a resident of one country in the other country can only be taxed by the source country if the income is attributable to a fixed base regularly available to the individual in the source country for the purpose of performing his or her activities.

(17) The proposed treaty prohibits source country tax on remuneration of a treaty country resident employed as a member of the regular complement of a ship or aircraft operating in international traffic. This is the same as the U.S. model provision, but differs from the present treaty (which provides no special rule for such employment income) and from the OECD model, which permits

taxation in such case by the country in which the place of effective management of the employer is situated.

(18) The proposed treaty allows directors' fees and similar payments made by a company resident in one country to a resident of the other country to be taxed in the first country if the fees are paid for services performed in that country. The U.S. model treaty and the present treaty, on the other hand, treat directors' fees as personal service income. Under the U.S. model treaty (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal service income and the source country tax on directors' fees is limited. By contrast, under the OECD model treaty the country where the company is resident has full taxing jurisdiction over directors' fees and other similar payments the company makes to residents of the other treaty country, regardless of where the services are performed. Thus, the proposed treaty represents a compromise between the U.S. model and the OECD model positions.

(19) As is true of the U.S. model treaty, the proposed treaty generally allows source country taxation of an entertainer or athlete who earns more than $20,000 there during a taxable year, without regard to the existence of a fixed base or other contacts with the source country. The existing treaty has no such provision, but would typically permit broader source country taxation of entertainers and athletes due to its greater latitude for source country taxation of independent personal services. Unlike the U.S. model, the entertainers and athletes article in the proposed treaty prohibits source country taxation of income derived on visits substantially supported by a government in the residence country.

(20) The proposed treaty provides for the treatment of alimony and child support payments, unlike the present treaty. The proposed treaty is similar to the U.S. model to the extent that it provides that alimony is taxable only where the recipient resides and that child support is taxable only in the source country. However, the proposed treaty has a different form in precluding source country tax on alimony only to the extent it is deductible to the payor and precluding residence country tax on "non-deductible" alimony. German internal law differs from U.S. internal law in limiting the amount of the alimony deduction by amount, and forbidding any deduction if the recipient is not subject to unlimited tax liability in Germany. The proposed treaty does not require Germany to allow a deduction in excess of the internal law monetary amount limitation, but it does, under the proposed protocol, require Germany to permit a deduction for payments to a U.S. resident without regard to the fact that the recipient is not subject to unlimited tax liability in Germany.

(21) The proposed treaty, unlike the present treaty, expressly provides for the taxation of social security benefits and other public pensions not arising from government service. While the U.S. model, and many existing U.S. treaties,[1] would permit only the

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[1] See U.S. income tax treaties with Australia, Barbados, Belgium, China, Cyprus, Finland, France, Hungary, Iceland, Jamaica, Korea, New Zealand, the Philippines, and Sri Lanka, and pending treaties such as Denmark, Indonesia, and India.

source country to tax such benefits, the proposed treaty permits taxation only by the residence country. In this respect the proposed treaty is similar to the U.S. treaties with Canada, Egypt, Italy, and Japan. The residence country is required, however, to treat benefits paid by the social security system of the other country as if they were paid by the residence country's system. Thus, for example, the treaty would give a U.S. resident receiving German benefits the right to the same degree of exclusion of the benefits from income (under Code section 86) as would apply if the benefits were paid by the U.S. social security system. In this respect the provision is unique to the proposed treaty, although the Canadian treaty provides for an exclusion from residence country tax for a portion of social security benefits from the other country. In addition, the saving clause does not apply to this provision of the treaty, which means that a U.S. citizen residing in Germany cannot be taxed by the United States, even on a residual basis, on U.S. social security benefits.

(22) The proposed treaty retains unchanged the present treaty's rule that employment compensation paid by a treaty country government may only be taxed by that country, by the United States in the case of a U.S. citizen or green card holder, or by Germany in the case of a German national. Unlike the U.S. and OECD models, and numerous existing U.S. income tax treaties, but like the present treaty, the proposed treaty does not permit taxation by the other country even when the services compensated are rendered in connection with a business carried on by a government.

(23) Like the present treaty, the proposed treaty exempts from U.S. tax German war reparations payments.

(24) Unlike the model treaties, but like the present treaty and a number of existing U.S. treaties with other countries, the proposed treaty generally prohibits source country tax on the teaching income of a resident of one country who visits the other country for two years or less to teach at an educational institution. Unlike the present treaty and the models, but like some other existing treaties, this same rule also applies under the proposed treaty to income received for carrying out advanced study or research at an institution engaged in research for the public benefit.

(25) The present and proposed treaties, unlike the models, preclude each country from taxing any grant, allowance, or award from a nonprofit religious, charitable, scientific, literary, or educational organization, received by a visiting person previously resident in the other country, unless the payments are compensation for personal services.

(26) The present and proposed treaties, unlike the models, also preclude the visited country from taxing certain compensation received by students, trainees, and certain other temporary visitors. The proposed treaty carries over from the present treaty an exemption from source country tax on compensation of residents of the other country, employed by enterprises of the other country or public charities, if they are present in the source country no more than one year for the purpose of acquiring technical, professional, or business experience from someone other than their employer, and their compensation does not exceed $10,000. The proposed treaty departs from both the models and the present treaty by gen-

erally precluding source country taxation of the first $5,000 of compensation received by a student, business apprentice, or grant recipient previously resident in the other country and present in the source country four years or less.

(27) The proposed treaty, unlike the present treaty, contains the standard "other income" article, found in the model treaties and some existing treaties, such as the U.S. treaty with the United Kingdom, under which income not dealt with in another treaty article generally may be taxed only by the residence country.

(28) The proposed treaty generally expands the applicability of the present treaty's German corporate tax exemption on dividends from U.S. companies. Under the proposed treaty, such dividends are not taxed by Germany when received by a German company directly owning 10 percent or more of the voting shares of the U.S. company. Under the present treaty, the exemption only applies if the German company owns 25 percent of more of the voting shares of the U.S. company. The proposed treaty, unlike the present treaty, however, provides no exemption if the dividend is paid by a RIC or otherwise has been deducted by the payor in computing taxable income.

(29) Generally, the present and proposed treaties preclude Germany from taxing U.S. source income which may be taxed by the United States under the treaty. In addition to the U.S. source dividends (described above) and U.S. government compensation paid to German nationals that under the present and proposed treaties may be taxed by Germany subject to a credit for U.S. tax, the proposed treaty adds additional categories of U.S. source income earned by German residents that may be so taxed by Germany: gains from the disposition of a U.S. real property interest other than real estate itself, directors' fees, income of athletes and entertainers taxable by virtue of the $20,000 ceiling on income exempt from tax at source, income that the treaty permits the United States to tax by reason of the limitation on benefits article, and certain income that would otherwise be subject to double tax or inappropriately reduced tax (for example, as a result of disagreements between the two countries over the tax treatment of an item of income or capital).

(30) The so-called "three-bites-of-the-apple" rule, applicable to U.S. citizens resident in Germany under the present treaty, is changed by the proposed treaty. Where the person earns income that in the hands of a German resident not a U.S. citizen would be subject to reduced or no U.S. tax under the treaty, Germany may limit the tax credit it provides for the U.S. tax on such amounts to the amount permitted by the treaty. The United States, in turn, is required to provide a credit for the German tax, and to resource the income if necessary to avoid double taxation. Under the present treaty, items that Germany would not be precluded by the treaty from taxing if earned by a noncitizen or nonresident of the United States are fully taxable by Germany, subject to a credit for U.S. taxes on U.S. source income.

(31) The proposed treaty expressly provides that the relief from double taxation article does not prevent internal German law from imposing a compensatory tax on U.S. source income distributed by a German company. Thus, although the German system for inte-

grating corporate and individual taxes generally gives refundable credits at the shareholder level for the corporate taxes borne on distributed profits, U.S. taxes paid by the corporation do not count as having been borne by the corporation for this purpose. Instead, if profits deemed to have borne U.S. tax but not German tax are distributed, an upward adjustment in German corporate tax is made, and shareholders receive the normal imputation credit. Under this rule, distributed profits taxed at the corporate level by the United States could theoretically be subject to two levels of taxation, once by the United States at 34 percent and once by Germany at the shareholder's full rate of tax.

(32) The proposed treaty greatly expands the non-discrimination rule in the present treaty, generally conforming it to the U.S. model. The present treaty prohibits only discrimination under the laws of one country against citizens of the other country resident in the first country. The proposed treaty prohibits discrimination under the laws of one country against nationals of the other country in the same circumstances as nationals of the first country. The proposed treaty also prohibits discrimination under the laws of one country against permanent establishments of enterprises of the other country, against the deductibility of amounts paid to residents of the other country, or against enterprises owned by residents of the other country.

(33) The proposed treaty requires a taxpayer to present a case for competent authority review within four years of the notification of the assessment giving rise to the alleged double taxation or taxation not in accord with the treaty. This contrasts with the absence of such a time limit under the present treaty and the U.S. model, and with the three-year limit under the OECD model.

(34) Like the U.S. model treaty, the proposed treaty makes express provision for competent authorities to mutually agree on topics that would arise under the present treaty, but are not mentioned in the present treaty's mutual agreement article, such as the characterization of particular items of income, the common meaning of a term, the application of procedural aspects of internal law, and the elimination of double taxation in cases not provided for in the treaty. Also like the U.S. model, the proposed treaty makes express provision for competent authorities to mutually agree on topics that would arise only under the proposed treaty, namely, the dollar thresholds in the artistes and athletes article and the students and trainees provisions. Finally, unlike the U.S. model or the present treaty, the proposed treaty makes express provision for competent authorities to mutually agree on the characterization of persons (e.g., whether an entity is a corporation or a partnership), on the treatment of income that is assimilated to income from shares by source country law and treated differently by the other country's law, on the elimination of any double taxation arising from Germany's application to its residents of part 4 of the German "Aussensteuergesetz" (the German analogue of subpart F of the Internal Revenue Code), and on common procedures different from those under national law for the allocation to a permanent establishment of expenses deductible in arriving at the business profits attributable thereto.

(35) The proposed treaty, unlike the present or model treaties, gives a taxpayer in a competent authority proceeding the right to present views to the competent authority of either or both of the countries.

(36) The proposed treaty provides for a binding arbitration procedure to be used to settle disagreements between the two countries regarding the interpretation or application of the treaty. The arbitration procedure, which for the United States is unique to the proposed treaty, can only be invoked by the agreement of both countries.

(37) Unlike the model treaties but similar to the present treaty, the proposed treaty provides that each country will exempt from tax organizations operated for religious, charitable, scientific, educational, or public purposes and treated as tax-exempt for that reason in the other country, if the organization would, but for its foreign activities and place of organization, qualify for exemption from tax in the first country.

(38) The proposed treaty contains a limitation on benefits, or "anti-treaty shopping," article similar to the limitation on benefits articles contained in recent U.S. treaties and protocols and in the branch tax provisions of the Code. The present treaty has no such article.

(39) The proposed treaty expressly provides that treaty reductions in withholding taxation on dividends, interest, royalties, and other amounts may be accomplished by refunds after withholding at the full statutory rate.

IV. Date of Entry Into Force and Termination

ENTRY INTO FORCE

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country and the instruments of ratification are to be exchanged as soon as possible in Washington. In general, the proposed treaty will enter into force when the instruments of ratification are exchanged, and a general effective date of January 1, 1990 is provided. The present treaty ceases to have effect once the provisions of the proposed treaty take effect. However, several changes from the present treaty rules are phased in over a longer period.

With respect to taxes withheld at source, and the excise tax on insurance premiums, the proposed treaty will be effective for amounts paid or credited on or after January 1, 1990. With respect to other income taxes, the treaty is to be effective for taxable years and assessment periods beginning on or after January 1, 1990, but excluding any fiscal year commencing before that date. With respect to capital taxes, the treaty is to be effective for tax levied on capital owned on or after January 1, 1990.

A taxpayer may elect to be taxed under the present treaty (in its entirety) for the first taxable year or assessment period with respect to which the proposed treaty would otherwise be in effect.

Direct dividends generally will not be immediately entitled to the 5 percent rate provided in Article 10. Such dividends paid or credited before January 1, 1992 may be taxed at rates up to 10 percent.

The U.S. branch tax applies only to dividend equivalent amounts for assessment periods or taxable years beginning on or after January 1, 1991. (For this purpose the dividend equivalent amount is deemed to be paid on the last day of the corporation's fiscal year.) The branch tax is to apply at the 5 percent rate from the beginning. In addition, earnings for prior periods will not be taken into account in computing the tax.

Any German tax exemption that would be applicable under the proposed treaty to dividends paid by a corporation, but for the fact that it is a regulated investment company (RIC), will be applicable to such dividends paid before January 1, 1991, if the RIC was in existence on October 1, 1988.

Certain amounts covered by the articles on interest and dividends, including those treated differently under the proposed treaty than under the present treaty, are subject to a special set of exceptions to the foregoing unless these amounts are earned by a permanent establishment or a fixed base in the source country of a resident of the other country. The present treaty, and not the proposed treaty, applies to interest as that term is used in the present treaty paid or credited before January 1, 1991. This rule applies to interest derived from a "partiarisches Darlehen," or a Gewinnobligation. Thus, amounts that are interest under the present treaty but that may be taxed under the internal law of the source country under the proposed treaty because they participate in profits and are deductible by the payor do not lose their source country tax exemption until 1991.

Income from a partiarisches Darlehen or a Gewinnobligation that will not be taxable in the source country to the full extent of its internal law, and income from a debt obligation treated under the proposed treaty as a dividend, will, if paid or credited on or after January 1, 1991, be eligible for the fully-phased-in proposed treaty rates on dividends.

Income derived under a Stille Gesellschaft, and income derived from jouissance shares or jouissance rights, which amounts may be taxed under the internal law of the source country under the proposed treaty because they participate in profits and are deductible by the payor, may be taxed in the source country at no more than 15 percent if paid or credited before January 1, 1991. Income derived under a Stille Gesellschaft, and income derived from jouissance shares or jouissance rights, which amounts may *not* be taxed under the internal law of the source country under the proposed treaty and must instead be taxed at rates no greater than the dividend rates, will be eligible for the fully-phased-in proposed treaty rates on dividends if paid or credited on or after January 1, 1990.

TERMINATION

The proposed treaty will continue in force indefinitely, but either country may terminate it by giving written notice through diplomatic channels before June 30 of any calendar year beginning after the expiration of the 5-year period from the date of its entry into force. A termination will be effective with respect to income of taxable years or assessment periods beginning (or, in the case of taxation at source or excise taxation of insurance premiums, amounts paid or credited) on or after the first day of January next following the date of termination specified in the notice of termination. (The termination will not be effective for any fiscal year beginning before that date.) The termination will be effective with respect to capital taxes levied on items of capital existing on or after that date.

V. COMMITTEE ACTION

The Committee on Foreign Relations held a public hearing on the proposed German income tax treaty and protocol, and on other proposed tax treaties, on June 14, 1990. The hearing was chaired by Senator Sarbanes. The Committee considered these proposed treaties on June 28, 1990, and ordered them favorably reported by a voice vote with certain understandings, with the recommendation that the Senate give its advice and consent to ratification of the proposed treaty and protocol.

VI. COMMITTEE COMMENTS

The Committee on Foreign Relations approved the treaty subject to an understanding with regard to the effect on the proposed treaty of any future unification of Germany. On balance, the Committee believes that this treaty is in the interest of the United States and urges that the Senate act promptly to give advice and consent to ratification. However, the Committee has taken note of certain issues raised by the proposed treaty, and believes that the following comments may be useful to U.S. Treasury officials in providing guidance on these matters should they arise the course of future treaty negotiations.

(1) IMPUTATION CREDIT

Unlike other European tax systems, German law integrates corporate and shareholder taxation by means of a hybrid system, combining "split" corporate-level tax rates, and shareholder credits for corporate tax.

Under German law, German resident shareholders subject to unlimited tax liability in Germany presently receive an income tax credit (or "imputation credit") equal to 56.25 percent of gross dividends paid by German resident companies. Germany also imposes a "split rate" on corporate income; under this system, earnings distributed by German resident companies as dividends, whether to resident or nonresident shareholders, are subject to a lower corporate income tax rate than are retained earnings. Currently, the tax rate on retained earnings (or "statutory burden") is 50 percent, and the corporate-level tax on distributed earnings (or "distribution burden") is 36 percent. Distributions are deemed to be made first out of corporate income which has borne at least a 36 percent tax. To the extent earnings distributed did not bear 36 percent German tax (regardless of whether they bore full U.S. or other foreign tax), an increased corporation tax will be imposed in the period of distribution to compensate for the amount of the shareholder credit in excess of the German corporate tax previously paid. The relief from double taxation article of the proposed treaty does not interfere with German internal law in this respect.

The proposed treaty provides U.S. portfolio investors in German resident companies (i.e., noncorporate U.S. investors and U.S. companies owning less than 10 percent of the voting shares of a German company) with a benefit relative to the generally applicable 15 percent source country treaty withholding rate, so long as a natural person resident in Germany is entitled under German law to an imputation credit (Anrechnung der Koerperschaftsteuer) for dividends paid by German resident companies. For German tax purposes, the benefit amounts not to a credit or refund of German corporate tax, but a reduction of 5 percentage points (i.e., from 15 to 10 percent) in the German withholding rate. For U.S. tax purposes, the benefit amounts to a 5.88 percent gross-up in income, and a foreign tax credit equal to approximately 15 percent of the grossed up amount. U.S. direct investors generally are entitled to no similar imputation benefit.

Under the proposed treaty, then, U.S. investors in German resident companies receive the benefit of the German split rate system, but receive a smaller imputation-related benefit than German shareholders in German resident companies receive for dividends paid by the companies. As a result, U.S. shareholders may be subject to higher German corporate and personal income taxes in connection with dividends received from German resident companies than are German shareholders. In addition, because no German shareholder-level credit is given for non-German corporate taxes, U.S. earnings of German companies may be subject to higher combined German and U.S. corporate and personal income taxes than are German earnings.

Several issues arise related to the German integration system. One issue is whether the United States should insist on the same tax relief for U.S. investors in German resident companies as German shareholders receive under German law. Another issue is whether the United States should give a credit for a flat 5.88 percent of every portfolio dividend in addition to the 10 percent German withholding tax, instead of insisting that credits be limited to all or some portion of a German refund of corporation tax (for which the treaty does not provide). A third issue is whether the United States should insist on Germany treating U.S. taxes paid by German companies the same as German taxes for purposes of computing the compensating burden on distributed profits.

The U.S. income tax treaties with the United Kingdom and France, which, like Germany, have imputation systems, generally provide U.S. portfolio investors with a credit based on the credit a U.K. or French resident would have received. On the other hand, the U.S. income tax treaty with Canada, and the proposed U.S. tax treaty with Finland, which countries also have imputation systems, do not allow U.S. shareholders in companies resident in those jurisdictions any portion of the imputation credit provided by those countries' statutes to domestic shareholders in domestic companies. Under present U.S. income tax treaties, no imputation system country except the United Kingdom allows U.S. direct investors any portion of the imputation credit provided its own residents. The U.S. treaty with the United Kingdom provides U.S. direct investors with a credit equal to one-half of the credit which an individual U.K. resident would be entitled to were he the recipient of the dividend.

The Treasury Department has in the past expressed the view that the most appropriate adjustment to German tax on U.S. investment in German companies would be for Germany to grant U.S. shareholders refunds of the full 36-percent German federal corporate tax on distributed profits.[2] Even assuming some relaxation in that view, the Committee notes that the amount of the benefit under the proposed treaty could be increased to more nearly equalize the burdens on U.S. and German investors. On the other hand, the Committee was informed that the treaty provides a German tax reduction on both portfolio and direct investment dividends relative to the present treaty, and, according to the negotiators, relative to every other German income tax treaty in force at the time the proposed treaty was signed. The Committee also understands that, unlike the U.K. and French systems, Germany gives a form of "full integration"—that is, all corporate level taxes are creditable at the shareholder level—only part of which is accomplished by the imputation credit. The German split rate system provides the remaining portion of the integration benefit, and that feature is not present in the U.K. or French systems. Moreover, the Committee believes that this is significant because the split rate benefits dividend recipients without regard to whether they reside within, or outside of, Germany.

Another issue is whether the fixed 5.88 percent U.S. credit constitutes "tax sparing" which would violate long-held United States tax treaty policy, or trigger any obligations of the United States to undertake to negotiate or provide tax-sparing benefits with respect to income earned in some of the other countries with which the United States has income tax treaties (e.g., China). The Committee believes that the treaty provides for no such tax sparing.

Tax sparing involves giving credit, against U.S. tax liability on foreign income, for source country taxes not actually paid. It has long been U.S. treaty policy not to enter into treaties providing for tax sparing of this kind. On the other hand, the operation of the U.K. and French treaty imputation credits has been said by some to amount to a form of "tax sparing," in the sense that the credit allowed to the U.S. shareholder exceeds the amount of shareholder level tax actually charged by the source country to the shareholder, or in the sense that the reduction in foreign shareholder-level tax is not matched dollar for dollar by an increase in U.S. tax through a reduction of the foreign tax credit.

The Committee believes that neither these treaties, nor the proposed treaty, provides for tax sparing in the sense of providing credits for phantom taxes, or reducing the sum of source country and residence country tax below the amount payable to the United States on income from a purely domestic investment. However, under the proposed treaty this result is avoided not because the amount of the additional benefit is based on a tax actually paid at the corporate level at the time of the distribution, as is the case, for example, under the U.K. treaty where the credit is based on the

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[2] Treasury Department News Release B-1703 (July 2, 1979).

Advance Corporation Tax (ACT) actually paid upon a distribution. The Committee believes that absence of tax sparing in this sense under the proposed treaty arises from the fact that the German corporate tax system imposes at least a 36 percent tax on all distributed profits, either when those profits are earned by the corporation, or when the compensating tax is paid on a distribution.

A third issue arising under the treaty is the failure of the German imputation system to treat U.S. income of a German corporation as having borne tax, for imputation credit purposes, to the extent of any portion of the U.S. taxes paid on that income. This failure may be said to impose a form of double taxation on the distributed U.S. earnings of a German company, even though the purpose of the treaty is to avoid double taxation. (Because distributions are deemed to be made first out of corporate income which has borne at least a 36-percent tax, dividends paid by German Companies with U.S. earnings may often not be subject to such double taxation in practice.) The Committee understands, however, that it appears to be a common feature of tax treaties (including the U.S.-U.K. and U.S.-France treaties) entered into by foreign countries that achieve a degree of integration through the imputation system. The Committee is aware that the Treasury and the Congress may ultimately conclude that the elimination of double taxation can better be achieved by developing alternative statutory or treaty systems (or both) for the treatment of dividends from sources in one country by a resident of the other. However, the Committee does not believe that a reservation or rejection of the proposed treaty would be warranted in order to effect a change at this time in the treatment for imputation credit purposes of U.S. income taxes imposed on German corporations.

(2) BRANCH TAX

Under the German tax system, the German profits of a branch of a foreign corporation are taxable at a flat rate, rather than under the split rate system. Currently, the flat rate is 46 percent. Under the U.S. tax system, the U.S. imposes income tax on the U.S. business income of foreign corporations at the same 34 percent rate imposed on U.S. corporate income. In addition, the U.S. imposes a 30 percent tax on the dividend equivalent amount of such a branch, which under the proposed treaty is reduced to 5 percent. As long as the German rate on branches of U.S. companies remains at least 5 percentage points greater than the German rate on distributed earnings of German companies (currently 36 percent), no German tax on the dividend equivalent amount of the German branch of a U.S. company may be imposed. If that difference were to fall below 5 percentage points, however, a German branch profits tax on a dividend equivalent amount would be permissible, but only if the sum of the income tax and dividend equivalent amount tax rates were no greater than 5 percentage points in excess of the German tax on distributed profits of German companies. The Committee is concerned about the reduction of the U.S. branch profits tax rate to 5 percent when in effect German branches of U.S. companies may be taxed at a rate as much as 10 percentage points greater than that applicable to German corporate earnings.

The Committee realizes that comparing the German rates of tax on branches of U.S. companies to the German rates on German companies is inherently imprecise, because the actual German rate on a German company varies as the proportion of earnings distributed varies. A German company that distributes no earnings faces a higher income tax rate than a German branch of a U.S. company. If a German company is wholly owned by a U.S. company and distributes all of its earnings so as to pay an average income tax rate of 36 percent, then its distributed earnings bear a total German income tax burden of approximately 39 percent, or the income tax rate plus approximately 3 percent, which is lower than the income tax rate on the German branch of a U.S. company.

Thus, depending on the particular distribution pattern of a German company, the tax imposed on the German branch of a U.S. company may be more or less than the German resident corporate rate on a comparable German company plus 5 percent of the dividend equivalent amount. The Committee believes that if the burden on the German branch were generally expected to exceed the comparable German company tax rate plus 5 percent of the dividend equivalent amount, then the United States has given German companies with U.S. branches benefits under the treaty which are not reciprocated by the German treatment accorded to U.S. companies with German branches. The Committee is unable to conclude that this is the case, however.[3]

The Committee understands that the Treasury Department generally takes the position in negotiating treaties that the branch tax rate may appropriately be set at the treaty direct dividend rate. Indeed, the self-executing provisions of the Code, which theoretically could apply to set the branch tax rate for a treaty country resident, also would set the branch tax rate at the treaty direct dividend rate in the absence of a contrary treaty specification. However, the Committee believes that in negotiating future treaties, the Treasury Department should take into account differences in rates of taxation charged to foreign and domestic companies under the internal laws of the other country, and should make appropriate adjustments to branch tax rates if such adjustments are warranted in light of the purposes of the branch tax.

(3) TREATY-SHOPPING

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty is intended to benefit residents of Germany and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries which do not have tax treaties with the United States, or from countries which have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may attempt to secure a lower rate of tax by lending money, for example, to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing a subsidiary, trust, or other investing entity in that treaty country which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

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[3] According to the Administration's written testimony submitted during the Committee's hearing on the proposed treaty, "given typical distribution patterns, one can generally view the 46 percent rate [the German income tax rate on a U.S. or other non-German corporation] as including an implicit branch tax." Notably, the rate of branch tax represented under these "typical distribution patterns" was not specified by the Administration. Thus, even the Administration was apparently not willing to commit to a conclusion at that time as to whether the branch tax provisions were or were not evenly reciprocal as to the rates charged.

The anti-treaty shopping provision of the proposed treaty is similar to an anti-treaty shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties. Some aspects of the provision, however, differ either from the anti-treaty shopping provision of the U.S. model or from the anti-treaty shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. The issue is whether the anti-treaty shopping provision of the treaty effectively forestalls potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed treaty is more lenient than the comparable rule in the U.S. model and other U.S. treaties. The U.S. model allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the country of residence, while the proposed treaty (like several newer treaties and an anti-treaty shopping provision in the Internal Revenue Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country (and citizens of the United States). Thus, this safe harbor is considerably easier to enter, under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the anti-treaty shopping article differs from the comparable rule of the U.S. model, but the effect of the change is less clear. The general test applied by the U.S. model to allow benefits, short of meeting the bright-line ownership and base erosion test, is a broadly subjective one, looking to whether the acquisition, maintenance, or operation of an entity did not have "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed treaty contains a more precise test that allows denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business. (However, this active trade or business test does not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed treaty gives the competent authority of the source country the ability to override this standard. The Memorandum of Understanding accompanying the treaty provides some elaboration as to how these rules will be applied.

The practical difference between the proposed treaty tests and the U.S. model test will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the standards in the proposed treaty and Memorandum of Understanding could be interpreted to require, for example, a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the proposed treaty tests (i.e., would operate to deny benefits in potentially abusive situations more often).

The Committee believes that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible, and in exercising any latitude Treasury has to adjust the operation of the proposed treaty, the Committee is particularly concerned that the rules as applied adequately deter treaty shopping abuses. The present income tax treaty between the United States and Germany does not contain anti-treaty shopping rules. Further, the proposed anti-treaty shopping provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Germany since third-country investors may be unwilling to share ownership of such investing entities on a 50–50 basis with U.S. or German residents or other qualified owners to meet the ownership test of the anti-treaty shopping provision. The base erosion test provides protection from certain potential abuses of a German conduit. Finally, Germany imposes significant taxes of its own; these taxes may deter third-country investors from seeking to use German entities to make U.S. investments. On the other hand, the Committee is aware that implementation of the tests for treaty shopping set forth in the treaty and interpreted in the Memorandum of Understanding may raise factual, administrative, or other issues that cannot currently be foreseen. The Committee emphasizes that the new rules must be implemented so as to serve as an adequate tool for preventing possible treaty-shopping abuses in the future.

(4) INSURANCE EXCISE TAX

The proposed treaty, unlike the present treaty, covers the U.S. excise tax on insurance premiums paid to foreign insurers. Thus, for example, a German insurer or reinsurer without a permanent establishment in the United States can collect premiums on policies covering a U.S. risk or a U.S. person free of this tax. However, the tax is imposed to the extent that the risk is reinsured by the German insurer or reinsurer with a person not entitled to the benefits of the proposed treaty or another treaty providing exemption from the tax. This latter rule is known as the "anti-conduit" clause.

Although waiver of the excise tax appears in the 1981 U.S. model treaty, waivers of the excise tax have raised serious Committee and other Congressional concerns. For example, concern has been expressed over the possibility that they may place U.S. insurers at a competitive disadvantage to foreign competitors in U.S. markets, if insubstantial tax is imposed by the other country to the treaty (or any other country) on the insurance income of its residents (or the income of companies with which they reinsure their risks). Moreover, in such a case waiver of the tax does not serve the purpose of treaties to avoid double taxation, but instead has the undesirable effect of eliminating all taxation.

The U.S.-Barbados and U.S.-Bermuda tax treaties each contained such a waiver as originally signed. In its report on the Bermuda treaty, the Committee expressed the view that those waivers should not have been included. The Committee stated that waivers should not be given by Treasury in its future treaty negotiations without prior consultations with the appropriate committees of Congress. Congress subsequently enacted legislation to ensure the sunset of the waivers in the two treaties. The waiver of the tax in the treaty with the United Kingdom (where the tax was waived without the so-called "anti-conduit rule") has been followed by a number of legislative efforts to redress perceived competitive imbalance created by the waiver.

The proposed treaty waives imposition of the excise tax on premiums paid to residents of Germany. The Committee understands that unlike Bermuda and Barbados, Germany imposes substantial tax on income, including insurance income, of its residents. Unlike the U.K. waiver, moreover, the German treaty waiver contains the standard anti-conduit language. Although it may be difficult to generalize about the precise tax burdens German insurers bear relative to U.S. insurers, or the precise effects of imposing or waiving the excise tax on German insurers' rates of economic return, on balance, and giving due consideration to the analysis provided by the Treasury Department with respect to this issue, the Committee believes that failure to impose the tax on German insurers is consistent with the criteria the Committee has previously laid down for waiver of the tax.

(5) EMPLOYEES OF A GOVERNMENT BUSINESS ENTERPRISE

The proposed treaty exempts employment compensation paid by a national or local government of one of the treaty countries from taxation by the other country, unless the employee is a national or citizen (or in the case of the United States, a green card holder) of the other country. Under the model treaties, unlike the present and proposed German treaties, employment compensation paid by a government of one country is exempt from tax by the other country only if the services rendered were in discharge of functions of a governmental nature. If the government is carrying on a business (as opposed to functions of a governmental nature), the ordinary provisions governing personal services income would apply under the model treaties to remuneration for services rendered in connection with the business. For example, under either the model or the present and proposed treaties, a German government official stationed in the United States to perform governmental functions is not subject to U.S. income tax. However, a person who is neither a U.S. citizen nor a U.S. green card holder, and who works for a U.S. business operated by the German government in the United States, would be taxable by the United States on his wages under the model treaties, but is not so taxable under the present and proposed treaties.

Such a rule is contrary to U.S. treaty policy as expressed in the model. It could operate to give a preference in employment to persons other than U.S. citizens and permanent residents. Its operation is likely to result largely in a reduction of U.S. tax on U.S. residents. Moreover, Congress in 1986 attempted though amendment of Code section 892 to better equate for income tax purposes the commercial functions directly or indirectly performed by foreign governments, on the one hand, and taxpayers in general, on the other. The Committee believes that, as a general matter, treaty language is inappropriate if it fails to distinguish between government employees performing government functions and government employees performing other functions, as does the language of the proposed treaty.

The Committee is not concerned about such language as applied to Germany, however, insofar as the Committee has been informed by the negotiators that the German Government does not and would not operate a business enterprise in such a way that its employees would benefit from the exemption. The Committee would be very concerned, however, were such language included in a treaty with a country that would operate business enterprises in such a fashion.

(6) SOCIAL SECURITY

Prior to 1983, U.S. social security benefit payments generally were excluded from gross income by the United States. In 1983, Congress removed the income exclusion on a portion, up to 50 percent, of social security benefit payments received by U.S. citizens and residents, and imposed a 30-percent withholding tax on one-half of the amount of social security benefit payments to nonresident aliens. Germany imposes tax on its social security benefits under a formula analogous to U.S. rules for taxing annuity income. Under those rules Germany may tax German social security benefits of a German person more or less heavily than the United States would tax the U.S. social security benefits of a similarly situated U.S. person.

For income tax purposes, the proposed treaty would require the United States to treat German social security payments received by U.S. citizens and residents as though they were U.S. social security benefits. Thus, the same income exclusions are to apply to such benefits. The same clause also prevents the United States from taxing U.S. social security payments made to U.S. citizens who are residents of Germany. The saving clause does not apply in this instance to give the United States even a residual right to tax this U.S. income of its citizens.

The United States frequently waives tax on U.S. source income that is earned by foreigners. The United States sometimes waives tax on foreign source income that is earned by U.S. persons (typically, but not always, through the foreign tax credit). The United States generally retains at least a residual right, however, to tax U.S. income of U.S. citizens. A recent exception to this policy involving social security benefits is the 1984 U.S.-Italy income tax treaty, but only for cases in which the U.S. citizen is also a citizen of Italy.[4] In 1985 the Committee reported out the Italy treaty with a statement that the precedential impact of this treaty provision could be significant. The Committee made it clear that in the future, proposed treaty provisions that would deny the United States the right to tax (at least residually) U.S. source income of U.S. persons who reside abroad will bear a substantial risk of Committee disapproval (Exec. Rep. 99-6, 99th Cong., 1st Sess. 10 (1985)).

The Committee is deeply concerned at the possibility that the Treasury may have paid insufficient heed to these comments in negotiating the German treaty. For example, in the written testimony submitted by the Administration to this Committee in June, the Administration stated that source country exemption of social security benefits does appear in other U.S. treaties, that the rule was very important to the German negotiators, and that before agreeing to this rule, the Treasury Department sought and received, in accordance with a prior understanding, the concurrence of the Social Security Administration. The Committee understands that these points are relevant to the broad question of whether German residents can properly be exempt from U.S. tax, but they are largely irrelevant to the concern raised in 1985, namely, that the United States should retain at least a residual right to tax its citizens resident abroad on their U.S. source income.

The Committee recognized in 1985 that the waiver of tax on U.S. citizen recipients of social security payments residing abroad in this instance might be thought to be of minor importance, because the waiver would apply to a limited class of individuals who would otherwise include at most one-half of the benefits in their gross income. (In the Italian treaty, the class was limited by the fact that it included only individuals who resided in Italy and were citizens of both the United States and Italy. In the German treaty, by contrast, the exemption from U.S. tax applies to any U.S. citizen residing in Germany.) In addition, in the case of the German treaty, whatever tax the United States could impose on such benefits by statute may in some cases be less than the tax that Germany imposes on such income by statute. The Committee's prior concern was and remains warranted on the grounds that the precedential importance of the Italian treaty rule as applied to U.S. citizens could be significant.

The Committee believes that its expression of concern with the defect in the Italian social security provision was adequate to inform the Treasury of the problem with that treaty. On the other hand, the Committee wishes not to conclude that the Administration deliberately ignored that concern. Perhaps the concern with the precedential effect of the rule as applied to the U.S. income of U.S. citizens may have been confused with the other concerns raised by the provision: for example, the more immediate revenue concerns of the Social Security Administration that were raised by the withholding tax exemption under that treaty that benefited all Italian residents except those, such as U.S. citizens, who are generally subject to U.S. tax on their worldwide income. Therefore the Committee, while strongly disapproving of the German treaty provision in its application, without a saving clause, in the case of U.S. income of a U.S. citizen, does not recommend a reservation or rejection of the treaty on this ground. However, the Committee fully expects that any future treaty in which the United States provides benefits similar to the benefits provided under the German treaty will not prevent the United States from imposing tax on the U.S. source income of its citizens.

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[4] In at least one other case (the 1984 French protocol), the United States has foregone the primary right to tax some U.S. source income paid to U.S. citizens.

(7) TAX ON STOCK GAINS

The United States does not now impose tax on U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations, with primarily two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real estate. The proposed treaty further provides that gains of German residents are exempt from U.S. tax unless they are gains from the disposition of U.S. real property interests, or gains from the alienation of personal property which forms or formed part of the business property of a permanent establishment or a fixed base in the United States. Thus, if a German person without a U.S. permanent establishment or fixed base owns stock in a U.S. corporation, any gains from the disposition of that stock will be exempt from U.S. tax under the treaty, regardless whether U.S. internal law is changed to provide for such a tax, unless that change is intended to override existing treaties.

In 1989 the House of Representatives passed a bill that would have taxed the gain on a disposition by a foreign person of stock in a U.S. corporation if the foreign person holds or held more than 10 percent of the stock of the U.S. corporation in the 5 years prior to the disposition.[5] This provision, had it been enacted into law, would have yielded to contrary existing treaties for a 3 year period and then overridden them subsequently. In the committee report on this provision, however, it was anticipated that in some cases, it could have been desirable for the United States to enter into treaties that would modify the effect of the provision on treaty country residents.

The override provision was considered by the Administration to be a serious defect in the bill, putting aside the more basic tax policy question whether such gains of foreign persons should be exempt in all cases from U.S. tax, when dividends paid by U.S. corporations to foreign persons are not, or whether it would not be more appropriate to treat stock gains no more favorably than dividends.

Bills have been introduced this year in both Houses of Congress that would tax as effectively connected income gains derived by foreign persons from the sale of stock of domestic corporations in cases where the foreign person holds or held at least 10 percent of the stock of the domestic corporation.[6] Unlike the unsuccessful House bill provision of 1989, the 1990 bills generally do not override existing contrary treaties. The proposed treaty would thus prevent the operation of the bill vis-a-vis German residents if the bill is passed.

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[5] H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989).

[6] H.R. 4308, sec. 201, 101st Cong., 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess. (1990).

As a general matter, the Committee is concerned about recommending consent to ratification of a treaty that forbids a tax that the Congress may decide to impose as the result of a change in its internal tax law policy. Although prior Congresses may have believed that the gains realized by foreign persons from the disposition of stock in U.S. companies were properly excluded, as a statutory matter, from the U.S. tax base, whether for reasons of administrability or for other reasons, Congress may decide that it is no longer appropriate to do so in the case of substantial foreign shareholders in U.S. companies. The Congress could further decide that, just as it is inappropriate in treaties to reduce source country taxation of dividends to zero, it is similarly inappropriate to reduce to zero the rate of tax on gain from stock that pays such dividends, or that it is inappropriate to reduce such tax to zero in all cases and for all types of dispositions.

Alternatively, the Congress could decide that, while a tax on stock gains should be imposed by statute, it may properly be waived in treaties, or at least treaties with countries that, in Congress's view, impose an adequate level of tax on the types of stock gains of its residents that would otherwise be subject to tax under the statute. As reflected in the OECD model and many existing treaties, for example, countries that do impose tax on the stock gains of foreign persons often waive such taxes in treaties, although because of differences in definitions of the term "gains" in other countries, those treaties may not operate in precisely the same manner as a U.S. income tax treaty, using U.S. definitions of the term "gain," would operate. (The U.S. model treaty also provides for waiver of the tax, but the U.S. model was last revised at a time when such a waiver would not have reduced any U.S. tax otherwise imposed by the Code, and thus could only have reduced foreign country taxes.)

Germany imposes a tax on certain stock gains of foreign persons. Moreover, imposition of that tax is prohibited under the present U.S.-Germany income tax treaty. Continued prohibition of that tax in the proposed treaty may thus be seen by some as a benefit to U.S. taxpayers (or the U.S. fisc) at the expense of the German fisc. Whether or not the Senate agrees to a new treaty with Germany, if Congress enacts the stock gains tax that the treaty protects German residents from paying, it is unclear whether the United States and Germany would agree to retention or removal of the present treaty restriction on each country's ability to tax stock gains of foreign persons. Consideration might be given, by both parties to the treaty, to questions such as the effect of Germany's similar tax under its internal law, and how the reciprocal imposition or elimination of this tax is likely to affect the taxation by Germany of U.S. residents, as well as the taxation by the United States of German residents.

The Committee does not believe that its general concern about entering into treaties in conflict with pending tax policy changes necessitates a reservation to this treaty. It is not clear if or when Congress will enact a tax on foreign persons' stock gains; if Congress does not do so, then there will have been no need to take action on this issue. In addition, the Congress might conclude that the waiver contained in the proposed treaty is in the best interests of the United States and its residents when taking into consideration the level of investment income flows between the United States and Germany that will result upon future realizations of stock gains that residents of each will have from disposing of stock of the other country's resident companies.

(8) ARBITRATION OF COMPETENT AUTHORITY ISSUES

In a step that has not been taken previously in U.S. income tax treaties, the proposed treaty makes provision for a binding arbitration procedure, if both competent authorities agree, for the resolution of those disputes in the interpretation or application of the treaty that it is within the jurisdiction of the competent authorities to resolve.

Generally, the jurisdiction of the competent authorities under the proposed treaty is as broad as it is under any U.S. income tax treaties. For example, the competent authorities are empowered (in this as in other treaties) to agree on the attribution of income, deductions, credits, or allowances of an enterprise to a permanent establishment. They may agree on the allocation of income, deductions, credits, or allowances between associated enterprises and others under the provisions of article 9 (Associated Enterprises), which is the treaty analogue of Code section 482. They may also agree on characterization of particular items of income, on the common meaning of a term, and on the application of procedural aspects of internal law. They may agree to raise the dollar thresholds in the articles dealing with entertainers and athletes, and with students and trainees.

Unlike the U.S. model or the present treaty, the proposed treaty also makes express provision for competent authorities to mutually agree on the characterization of persons (e.g., whether an entity is a corporation or a partnership), on the treatment of income that is assimilated to income from shares by source country law and treated differently by the other country's law, on the elimination of any double taxation arising from Germany's application to its residents of part 4 of the German "Aussensteuergesetz" (the German analogue of subpart F of the Internal Revenue Code), and on common procedures different from those under national law for the allocation to a permanent establishment of expenses deductible in arriving at the business profits attributable thereto. Finally, the competent authorities may agree on the elimination of double taxation in cases not provided for in the treaty. According to the Treasury Department's Technical Explanation of the rules, agreements reached by the competent authorities need not conform to the internal law provisions of either treaty country.

As an initial matter, it is necessary to recognize that there are appropriate limits to the competent authorities' own scope of review.[7] The competent authorities would not properly agree to be

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[7] In discussing a clause permitting the competent authorities to eliminate double taxation in cases not provided for in the treaty, Representative Dan Rostenkowski, Chairman of the House

Continued

bound by an arbitration decision that purported to decide issues that the competent authorities would not agree to decide themselves. Even within the bounds of the competent authorities' decision-making power, there likely will be issues that one or the other competent authority will not agree to put in the hands of arbitrators. Consistent with these principles, the notes exchanged on the signing of the treaty provide that the competent authorities will not generally accede to arbitration with respect to matters concerning the tax policy or domestic tax law of either treaty country.

The Committee believes that the tax system potentially may have much to gain from use of a procedure, such as arbitration, in which independent experts can resolve disputes which otherwise may impede efficient administration of the tax laws. If an understanding of, and experience with, the potential benefits or difficulties of such procedures is to be more fully developed, an experiment involving cooperation with a tax administration such as Germany's should be an appropriate way to develop that understanding and experience. However, the Committee also believes that the appropriateness of such a clause in a future treaty will depend strongly on the other party to the treaty, and the experience that the competent authorities have under the provision in the German treaty.

(9) UNIFICATION OF GERMANY

The proposed treaty applies to residents of, and income derived from sources within, the Federal Republic of Germany. The term "Federal Republic of Germany," when used in a geographical sense, means the area in which the tax law of the Federal Republic of Germany is in force. It is possible that the states of the German Democratic Republic (GDR) and the Federal Republic of Germany (FRG) may unite under a single national government in the foreseeable future. The Committee was informed that if the states currently in the GDR were to merge into the FRG, the proposed treaty might be made applicable to the unified Germany, upon further actions of the German Government which could be taken following unification. If a different legal process of unification were to occur, application of the treaty to the unified Germany would depend on the legal process of unification chosen, including perhaps in addition, future actions by the United States. The Committee has been informed by the Administration that the German Finance Ministry intends to consult with the Administration before there can be any changes in the geographic coverage of the treaty. The Administration further indicated its intent to forward future confirmation of that commitment to the Committee.[8]

Ways and Means Committee, submitted the following testimony in 1981 hearings before the Senate Foreign Relations Committee:

"Under a literal reading, this delegation could be interpreted to include double taxation arising from any source, even state unitary tax systems. Accordingly, the scope of this delegation of authority must be clarified and limited to include only noncontroversial technical matters, not items of substance."

Tax Treaties: Hearings on Various Tax Treaties Before the Senate Comm. on Foreign Relations, 97th Cong., 1st Sess. 58 (1981).

[8] Letter dated June 25, 1990 to Senator Sarbanes from Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury.

The Committee has considered the proposed treaty under the assumption that there is a single national tax law of the FRG, and that any extension of the treaty to new territory that might be added to the FRG would depend on the similar extension of the FRG taxes covered by the proposed treaty to the new territory. Consistent with this belief, the Committee understands that in the event the GDR and the FRG unite under the Government of the FRG, the Convention will apply, according to its terms, to residents of the area currently comprising the GDR, and generally to income from sources within (and to capital situated in) that area, only at such time as the laws imposing the covered national taxes in the area currently comprising the GDR and the laws imposing the covered national taxes in the area currently comprising the FRG are identical in substance. The Committee believes that it is appropriate for the Senate to give its advice and consent to ratification of the proposed treaty subject to that understanding.

VII. Budget Impact

The Committee has been informed by the staff of the Joint Committee on Taxation that the proposed treaty is estimated to decrease annual budget receipts by less than $50 million.

VIII. Explanation of Treaty Provisions

A detailed article-by-article explanation of the proposed income tax treaty between the United States and Germany is presented below. This explanation includes a discussion of the proposed protocol under the treaty articles amended by it. Also presented below are explanations of the notes exchanged when the proposed treaty was signed.

ARTICLE 1. PERSONAL SCOPE

The personal scope article describes the persons who may claim the benefits of the proposed treaty. Paragraph 1 of the proposed protocol contains other rules regarding the general scope of the treaty, including the "saving clause."

The proposed treaty generally applies to residents of the United States and to residents of Germany, with specific exceptions designated in other articles (e.g., Articles 24 (Nondiscrimination) and 26 (Exchange of Information and Administrative Assistance)) and discussed below. This follows other U.S. income tax treaties, the U.S. model income tax treaty, and the OECD model income tax treaty. Residence is defined in Article 4.

The proposed protocol provides that it does not restrict any benefits accorded by internal law or by any other agreement between the United States and Germany. Thus, the treaty will apply only where it benefits taxpayers.

Like all U.S. income tax treaties, the proposed treaty is subject to a "saving clause," here contained in the proposed protocol. Under this clause, with specific exceptions described below, the treaty is not to affect the taxation by the United States of its residents or its citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are residents of Germany as if the treaty were not in force. "Residents" for purposes of the treaty (and thus, for purposes of the saving clause) include corporations and other entities as well as individuals (Article 4 (Residence)).

Under Code section 877 ("Expatriation to avoid tax"), a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes, will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship. The treaty contains the standard provision found in the U.S. model and most recent treaties specifically retaining the right to tax former citizens. Even absent a specific provision the Internal Revenue Service has taken the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).

Exceptions to the saving clause are provided for certain benefits conferred by the United States, namely: correlative adjustments to the income of enterprises associated with other enterprises the profits of which were adjusted by Germany (Article 9, paragraph 2); reductions in U.S. tax on certain stock gains of U.S. residents who are German expatriates, and who may be taxed by Germany on those gains (Article 13, paragraph 6); limitations on taxation of alimony and child support (Article 18, paragraphs 3 and 4); exemption from taxation on German war reparations (Article 19, paragraph 1(c)); treatment of German social security benefits as though they were U.S. social security benefits, and exemption from U.S. tax on U.S. social security benefits paid to residents of Germany (Article 19, paragraph 2); relief from double taxation (Article 23); nondiscrimination (Article 24); and mutual agreement procedures (Article 25).

In addition, the saving clause does not apply to the following benefits conferred by the United States upon individuals who are not U.S. citizens and do not acquire immigrant status in the United States: exemption from tax on compensation from German government service (Article 19, paragraph 1(b)); exemption from tax on certain teaching or research income, on certain German-source payments for the purposes of educating and supporting students and business apprentices, on grants from non-profit and public institutions, and on limited amounts of compensation received by students and trainees (Article 20); and certain fiscal privileges of diplomats referred to in the treaty (Article 30). For U.S. purposes, an individual has "immigrant status" in the United States if he has been admitted to the United States as a permanent resident under U.S. immigration laws (i.e., he holds a "green card").

The saving clause provisions of the proposed protocol relate mainly to the treatment by the United States of its citizens and residents (as defined under the treaty), as opposed to the treatment by Germany of its residents or citizens. This is generally consistent with Article XV, paragraph 1(a), of the present treaty. It is a departure, however, from the U.S. model and existing U.S. treaties, under which as a general rule (excepting a few existing treaties such as those with China, Finland, France, Norway) the saving clause is reciprocal. However, the protocol does contain a clause reserving to Germany the right to impose its taxes on German residents under part 4 of the German "Aussensteuergesetz." This is a law, similar to subpart F of the Internal Revenue Code, generally requiring inclusions in the income of German residents of certain "intermediate company" income of certain controlled foreign entities. The proposed protocol also provides that where such imposition of tax gives rise to double taxation, the competent authorities shall consult for its elimination in accordance with the general procedures for resolving issues of treaty application.

ARTICLE 2. TAXES COVERED

The proposed treaty generally applies to the income taxes of the United States and Germany, and to the German tax on capital.

United States

In general

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Internal Revenue Code, but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes. In addition, subject to an "anti-conduit rule," the proposed treaty applies to the U.S. excise tax imposed on insurance premiums paid to foreign insurers.

Tax on insurance premiums

Code rules.—Under the Code the United States imposes an excise tax on certain insurance premiums received by a foreign insurer from insuring a U.S. risk or a U.S. person (Code secs. 4371–4374). Unless waived by treaty, the excise tax applies to those premiums which are exempt from U.S. net basis income tax. Under the Code (in the absence of a contrary treaty provision), a foreign insurer is subject to U.S. net basis income tax on income in situations where that insurance income is effectively connected with a U.S. trade or business. However, a foreign insurer insuring U.S. risks ordinarily will not be viewed as conducting a U.S. trade or business, and thus will not be subject to U.S. income tax, if it has no U.S. office or agent and operates in the United States solely through independent brokers. In these situations, the insurance excise tax is imposed (except as otherwise provided in a treaty) on the premiums paid for that insurance.[9]

The excise tax may be viewed as serving the same function as the tax imposed on dividends, interest, and other types of passive income paid to foreign investors. In general, the excise tax applies to insurance covering risks wholly or partly within the United States where the insured is (1) a U.S. person or (2) a foreign person engaged in a trade or business in the United States. Under the Code, the excise tax generally applies to a premium on any such insurance unless the amount is effectively connected with the conduct of a trade or business in the United States and not exempt by treaty from the statutory net basis tax.

The treatment of insurance income of foreign insurers is complicated somewhat in situations where, as is usually the case, some portion of the risk is reinsured with other insurers in order to spread the risk. In situations where the foreign insurer is engaged in a U.S. trade or business and thus subject to the U.S. income tax, reinsurance premiums, whether paid to a U.S. or a foreign reinsurer, are allowed as deductions. Accordingly, the foreign insurer is taxable only on the income attributable to the portion of the risk it retains. However, while generally no excise tax is imposed on the insurance policy issued by the foreign insurer doing business in the United States, the one-percent excise tax on reinsurance is imposed if and when that insurer reinsures that U.S. risk with a foreign insurer not subject to U.S. net basis income tax.

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[9] The excise tax is currently imposed at a rate of four percent of the premiums paid on casualty insurance and indemnity bonds, and one percent of the premiums paid on life, sickness, and accident insurance, annuity contracts, and reinsurance (Code secs. 4371–4374).

Proposed treaty.—The insurance excise tax described above is covered by the proposed treaty, but only to the extent that the foreign insurer does not reinsure the risks in question with a person not entitled to relief from this tax under the proposed treaty or another U.S. treaty.

More specifically, income of a German insurer from the insurance of U.S. risks or U.S. persons will not be subject to the insurance excise tax (except in situations where the risk is reinsured with a company not entitled to the exemption). This waiver applies notwithstanding that insurance income is not attributable to a U.S. permanent establishment maintained by the German insurer and hence not subject to U.S. net basis tax pursuant to the business profits article (Article 7) and other income article (Article 21). This treatment is a departure from the existing tax treaty with Germany, but is similar to that provided in some other recent U.S. tax treaties, for example, the treaties with France and Hungary, and the pending treaties with Finland, India, and Spain. The excise tax on premiums paid to foreign insurers is a covered tax under the U.S. model treaty.

In exempting from the U.S. income tax and the insurance excise tax all insurance income which is not attributable to a permanent establishment in the United States, the proposed treaty makes two changes in the statutory rules governing the taxation of insurance income of German insurers. First, any insurance income which is effectively connected with a U.S. trade or business but is not attributable to a U.S. permanent establishment will not be subject to U.S. income tax. This exemption is contained in the existing treaty. As is true under the existing treaty, those German insurers which continue to maintain a U.S. permanent establishment after the proposed treaty enters into force will remain subject to the U.S. income tax on their net U.S. insurance income attributable to the permanent establishment.

Second, German insurers not engaged in a U.S. trade or business generally will no longer be subject to the insurance excise tax. This exemption is not contained in the existing treaty. The insurance excise tax will continue to apply, however, in situations where a German insurer with no U.S. trade or business reinsures a policy it has written on a U.S. risk with a foreign reinsurer, other than a resident of Germany or another insurer entitled to exemption under a different tax treaty (such as the U.S.-France treaty). The tax liability may be imposed on the German insurer which in this situation is viewed as the U.S. resident person transferring the premium to the foreign reinsurer. The excise tax will apply to such reinsurance even where the German insurance company has a U.S. trade or business, but no U.S. permanent establishment, and thus will not be subject to U.S. *income* tax on the net income it derives on the portion of the risk it retains.

For example, assume a German company not engaged in a U.S. trade or business insures a U.S. casualty risk and receives a premium of $200. The company reinsures part of the risk with a Danish insurance company (not currently entitled to exemption from the excise tax) and pays that Danish company a premium of $100. The four-percent excise tax on casualty insurance applies to the premium paid to the German insurance company to the extent of the $100 reinsurance premium. Thus, the U.S. insured is liable for an excise tax of $4, which is four percent of the portion of its premium paid to the German insurer which was used by the German insurer to reinsure the risk. It is the responsibility of the U.S. insured to determine to what extent, if any, the risk is to be reinsured with a nonexempt person. Under an administrative procedure currently in effect, the burden of this responsibility effectively can be shared with the German insurer (*see* Rev. Proc. 87-13, 1987-1 C.B. 596).

Germany

In the case of Germany, the proposed treaty, like the existing treaty, applies to the income tax (Einkommensteuer), the corporation tax (Koerperschaftsteuer), the trade tax (Gewerbesteuer), and the capital tax (Vermoegensteuer).

Other rules

For purposes of the nondiscrimination article (Article 24), the treaty applies to taxes of all kinds imposed by the countries, including any taxes imposed by their political subdivisions or local authorities. For purposes of the exchange of information article (Article 26), the proposed treaty provides that the United States and Germany may, through diplomatic channels, exchange notes under which they may apply that article to other U.S. and German taxes. Under the U.S. model, broad application of the exchange of information article to all national taxes would be automatic.

The proposed treaty also contains a provision generally found in U.S. income tax treaties (including the present German treaty) to the effect that it will apply to any identical or substantially similar taxes that either country may subsequently impose. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in its internal tax laws. This clause is similar, but not identical, to U.S. model treaty language.

ARTICLE 3. GENERAL DEFINITIONS

Certain of the standard definitions found in most U.S. income tax treaties are contained in the proposed treaty.

The term "Contracting State" means the United States or Germany, as the context requires.

The term "United States," when used in a geographical sense, means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. Under Code section 638, where the term is used in a geographical sense, it includes the continental shelf: that is, the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. Under the proposed treaty, these same areas are considered part of the United States for treaty purposes.

The term "Federal Republic of Germany," when used in a geographical sense, means the area in which the tax law of the Federal Republic of Germany is in force.[10] The Committee understands that this language generally is intended to signify Germany excluding the area of German Democratic Republic. It includes the German continental shelf. Under Article 31 of the proposed treaty, it also includes Land Berlin, unless the German government makes a contrary declaration to the U.S. government within three months of the date of entry into force of the proposed treaty.

The term "person" includes, but is not limited to, an individual and a company. According to the Treasury Department's Technical Explanation of the proposed treaty and protocol, this definition is not intended by the Treasury as a departure from the U.S. model, which states that the term "person" also includes an estate or trust and any other body of persons. A "company" is any body corporate or any entity which is treated as a body corporate for tax purposes.

An enterprise of a country is defined as an enterprise carried on by a resident of that country. The treaty does not define the term "enterprise."

The proposed treaty defines "international traffic" as any transport by a ship or aircraft except when the ship or aircraft is operated solely between places in one of the contracting states. Accordingly, with respect to a German enterprise, purely domestic transport in the United States is excluded.

Under the proposed treaty a person is considered a U.S. national if the person is an individual U.S. citizen or any legal person, partnership, or association deriving its status as such from the law in force in the United States.

An individual is considered a German national if he or she is a German with the meaning of paragraph 1 of Article 116 of the Basic Law of the Federal Republic of Germany. Under that law, a person is a German if he or she either possesses German citizenship or has been admitted to the territory of the German Reich within the frontiers of 31 December 1937 as a refugee or expellee of German stock or as the spouse of descendant of such person. Any legal person, partnership, or association deriving its status as such from the law in force in Germany is also considered a German national under the treaty.

The U.S. competent authority is the Secretary of the Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Assistant Commissioner (International) of the IRS. On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS.

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[10] The Committee understands that the Federal Republic of Germany (FRG) and German Democratic Republic (GDR) recently entered into a treaty for economic union which contemplates that the GDR will adopt certain FRG tax rules effective January 1, 1991. If such laws were adopted by the GDR, the Committee understands that such an adoption would not have the effect of extending the application of the treaty to the GDR.

The German competent authority is the Federal Minister of Finance or his delegate.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms not defined in the treaty are to have the meanings which they have under the laws of the country applying the treaty.

ARTICLE 4. RESIDENCE

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning one of the countries as the country of residence where, under the internal laws of the countries, a person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on his U.S. source income and on his income that is effectively connected with a U.S. trade or business. A company is a resident of the United States if it is organized in the United States. An individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident (Code sec. 7701(b)). A permanent resident for immigration purposes (i.e., a green card holder) also is a U.S. resident. The standards for determining residence provided in the Code do not alone determine the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States.)

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that country, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. However, the term "resident of a Contracting State" does not include any person who is liable to tax in that country in respect only of income from sources in, or capital situated within, that country. A partnership, estate, or trust will be considered to be a resident of a country only to the extent that the income it derives is subject to that country's tax as the income of a resident, either in its hands or in the hands of its partners or beneficiaries. For example, if the share of U.S. beneficiaries in the income of a U.S. trust is only one-half, Germany would have to reduce its withholding tax on only one-half of the German source income paid to the trust.

This provision of the proposed treaty is generally based on the fiscal domicile article of the U.S. and OECD model treaties and is similar to the provisions found in other U.S. tax treaties. Consistent with most U.S. income tax treaties, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas are not necessarily entitled to the benefits of the treaty as U.S. residents. Paragraph 2 of the proposed protocol provides instead that Germany shall treat a U.S. citizen or U.S. green card holder as a U.S. resident only if the person has a substantial presence, permanent home, or habitual abode in the United States. This result is contrary to U.S. treaty policy as expressed in the U.S. model, but the U.S. model result has been achieved in few treaties. "Substantial presence" is a defined term under the Code definition of residence in Code section 7701(b); "permanent home" and "habitual abode" are terms frequently used in treaty "tie-breaker" rules, as described below.

A set of "tie-breaker" rules is provided to determine residence in the case of an individual who, under the basic residence rules, would be considered to be a resident of both countries. Such a dual resident individual will be deemed to be a resident of the country in which he has a permanent home available to him. If this permanent home test is inconclusive because the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his personal and economic relations are closer, i.e., his "center of vital interests." If the country in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either country, he shall be deemed to be a resident of the country in which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he shall be deemed to be a resident of the country of which he is a national. If he is a national of both countries or neither of them, the competent authorities of the countries are to settle the question of residence by mutual agreement.

In the case of a person other than an individual that is resident of both countries under the basic treaty definition, the treaty requires the competent authorities of the two countries to seek to assign a single country of residence through consultation. If they are unable to make such a determination, the person will be considered a resident of neither treaty country for purposes of receiving any treaty benefits. (Such a dual resident may be treated as a treaty country resident for other purposes, however, such as entitling a person receiving a dividend from a dual resident (in the case of a dual resident corporation) to reduced source country taxation on the dividend.) In this regard the proposed treaty is similar to some other existing treaties, but dissimilar to the U.S. model treaty which does not specify absence of treaty benefits in cases where the competent authorities cannot agree.

ARTICLE 5. PERMANENT ESTABLISHMENT

The proposed treaty contains a definition of the term "permanent establishment" that generally follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties will apply, or whether those amounts will be taxed as business profits. Taxation of business profits is discussed under Article 7 (Business Profits).

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which an enterprise engages in business. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes any building site or construction, assembly, or installation project, if the site or project lasts for more than 12 months. The 12-month period for establishing a permanent establishment in connection with a site or project corresponds to the rule of the U.S. model treaty.

The general rule is modified to provide that a fixed place of business that is used for any of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the enterprise and the maintenance of a stock of goods belonging to the enterprise solely for storage, display, or delivery, or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise; this specification is part of the U.S. model but is new in relation to the present German treaty. These activities include as well the maintenance of a fixed place of business solely for the purpose of advertising, of the supply of information, of scientific activities, or of similar activities for the enterprise that have a preparatory or auxiliary character; this specification is part of the present German treaty but is not found in the U.S. or OECD models.

Under the U.S. model treaty, the maintenance of a fixed place of business solely for any combination of these activities will not constitute a permanent establishment. Under the proposed treaty, a fixed place of business used solely for any combination of these activities will not constitute a permanent establishment, provided that the overall activity of the fixed place of business is of a preparatory or auxiliary character. Neither clause appears in the present German treaty.

If a person has, and habitually exercises, the authority to conclude contracts in a country on behalf of an enterprise of the other country, then the enterprise generally will be deemed to have a permanent establishment in the first country. Consistent with the model treaties, this rule does not apply where the contracting authority is limited to those activities (described above) such as storage, display, or delivery of merchandise which are excluded from the definition of permanent establishment. Under the present treaty this exception only applies where the exercise of authority is limited to the purchase of goods or merchandise for the account of the enterprise. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or any other agent of independent status acting in the ordinary course of its business.

The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a company that is a resident of the other country or to a company that engages in business in that other country. Such relationships are thus not relevant; only the activities of the company being tested are relevant.

The permanent establishment article is modified by paragraph 3 of the proposed protocol, under which a resident of one country that performs in the other country concerts, theatrical or artistic performances, or similar shows and revues and that may not be taxed in the performance country under the provisions of Article 17 (Artistes and Athletes) shall not be deemed to have a permanent establishment in the performance country if its presence does not exceed in the aggregate 183 days in the calendar year concerned.

ARTICLE 6. INCOME FROM IMMOVABLE (REAL) PROPERTY

This article covers income from "immovable" (or for U.S. purposes, real) property. The rules covering gains from the sale of immovable property are in Article 13.

Under the proposed treaty, income derived by a resident of one country from immovable property situated in the other country may be taxed in the country where the immovable property is located. Income from immovable property includes income from agriculture or forestry.

The term "immovable property" has the meaning which it has under the law of the country in which the property in question is situated. For property situated in the United States, the term means "real property" as defined by U.S. law. The term in any case includes property accessory to immovable property; livestock and equipment used in agriculture and forestry; rights to which the provisions of general law respecting landed property apply; usufruct of immovable property; and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources. Thus, income from immovable property includes royalties and other payments in respect of the exploitation of natural resources (e.g., oil). It does not include interest on loans secured by real property. Ships and aircraft are not real property.

The source country may tax income derived from the direct use, letting, or use in any other form of immovable property. These rules allowing source country taxation also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

The present treaty, the U.S. model treaty, and certain other U.S. income tax treaties provide residents of one country with an election to be taxed on a net basis by the other country on income from real property in that other country. The proposed treaty does not contain that election, but a net basis election is provided for U.S.

real property income under the Code (secs. 871(d) and 882(d)). The Committee understands that Germany also provides for taxation of income from immovable property on a net basis.

ARTICLE 7. BUSINESS PROFITS

U.S. Code rules

U.S. law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (thus it is said to be taxed as if it were business income under a limited "force of attraction" rule).

In the case of foreign persons other than insurance companies, foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. For such persons, only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States, or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office.

The foreign source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code may be treated as U.S.-effectively connected without regard to the foregoing rules, so long as such income is attributable to its U.S. business. In addition, the net investment income of such a company which must be treated as effectively connected with the conduct of an insurance business within the United States is not less than an amount based on a combination of asset/liability ratios and rates of return on investments experienced by the foreign person in its world-wide operations and by the U.S. insurance industry.

Trading in stocks, securities, or commodities in the United States for one's own account generally does not constitute a trade or business in the United States, and accordingly, income from those activities is not taxed by the United States as business income. Thus, income from trading through a U.S.-based employee, a resident broker, commission agent, custodian, or other agent, or from trading by a foreign person physically present in the United States is not generally taxed as business income. However, this rule generally does not apply to a dealer, or, in the case of trading in stocks or securities, to a corporation the principal business of which is trading in stocks or securities for its own account, if its principal office is in the United States.

The Code as amended by the Tax Reform Act of 1986 provides that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year (Code sec. 864(c)(6)). In addition, the Code provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Proposed treaty rules

Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits, and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Profits from U.S. source income other than U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains, are treated as effectively connected with the conduct of a trade or business in the United States, and taxed as such by the United States, without regard to whether they were derived from business activities or business assets. Under the proposed treaty, by contrast, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.

The business profits of a permanent establishment are determined on an arm's length basis. Thus, there are to be attributed to a permanent establishment the business profits which would reasonably be expected to have been derived by it if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions. For example, this arm's length rule applies to transactions between the permanent establishment and a branch of the resident enterprise located in a third country. Amounts may be attributed to the permanent establishment whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions are allowed for expenses, wherever incurred, which are incurred for the purposes of the permanent establishment. These deductions include a reasonable amount of executive and general administrative expenses, research and development expenses, interest, and other similar expenses. Under this language, which differs in minor respects from the U.S. model, the Committee understands that, as indicated by Treasury in its Technical Explanation, the United States is currently free to use its expense allocation rules in determining the reasonable amount. Thus, for example, a German company which has a branch office in the United States but which has its head office in Germany will, in computing the U.S. tax liability of the branch, be entitled to deduct a portion of the executive and general administrative expenses incurred in Germany by the head office, allocated and apportioned in accordance with Treas. Reg. sec. 1.861-8, for purposes of operating the U.S. branch. However, under paragraph 6 of the proposed protocol, the U.S. and German competent authorities may mutually agree to common procedures different from those under national law for the allocation to a permanent establishment of such expenses.

Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for the account of the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element in its purchasing activities.

Neither the proposed treaty nor the present treaty contain the language of the U.S. model and many existing treaties, under which the amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method. However, the Committee understands that this does not give taxpayers any right to take inconsistent positions from year to year that would be impermissible under the model treaty language.

The present treaty contains a "force of attraction rule" similar to, but broader than, the force of attraction rule contained in the Code as described above. Under the present treaty, an enterprise of one country is taxable by the other country both on industrial or commercial profits actually derived and *deemed* to be derived through a permanent establishment in the other country. The proposed treaty eliminates this rule, providing instead that the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment. Thus, the proposed treaty not only departs from the present treaty but also from the more limited force of attraction rule in the Code. The proposed treaty is consistent with the model treaties and other existing U.S. treaties in this respect.

Paragraph 4 of the proposed protocol clarifies that, for purposes of the treaty rules stated above (and for purposes of article 13 (gains)), any income, gain or expense attributable to a permanent establishment (or fixed base) during its existence is taxable or deductible in the country where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) has ceased to exist. Nothing in this paragraph of the proposed protocol affects the application to the deferred payment of internal law rules regarding the accrual of income and expenses.

Paragraph 5 of the proposed protocol restricts the application of the 1986 Act U.S. rule for taxing the gain on property previously used or held for use in connection with the conduct of a trade or business in the United States, as well as a comparable German law rule. Under the proposed protocol, gain from the alienation of movable property that at any time formed part of the business property of a permanent establishment or fixed base that a resident of one country has or had in the other country may be taxed by the second country only to the extent of the gain that accrued during that time. The tax may be imposed at the time the gain is realized and recognized under the laws of the second country, if it is within ten years of the date on which the property ceased to be part of the business property of the permanent establishment or fixed base (or such shorter period provided by the laws of either country). Thus, if under the laws of either Germany or the United States such a gain could only be taxed if the gain were realized and recognized within 5 years of the time the property ceased to be part of the relevant business, then both countries would forego tax on such gains realized more than 5 years from the cessation. Currently German internal law provides for tax on the gain accrued while the property was part of a German business, with no time limit as to realization of gain after the property ceased to be such a part.

There is no U.S. or OECD model provision permitting imposition of the U.S. rule addressed by this paragraph of the proposed protocol. The single U.S. treaty that has been updated by provisions now in force to take into account the 1986 Act amendments, namely, the U.S.-France treaty, does not permit imposition of the rule. Nor do the pending treaties with Finland, Indonesia, or Tunisia.

For purposes of the proposed treaty, the term "business profits" includes income derived from the rental of tangible personal property and income from the rental or licensing of cinematographic films or works on film, tape, or other means of reproduction for use in radio or television broadcasting. The treaty definition of business profits, and the treaty business profits rules generally, are similar to those provided in the U.S. model treaty. The Committee understands that, while the U.S. model includes words to the effect that the term "business profits" means income derived from any trade or business, the absence of this definition from the proposed treaty is not intended to indicate any difference in the meaning to be attributed to the term.

Where business profits include items of income which are dealt with separately in other articles of the treaty, those other articles, and not the business profits article, will govern the treatment of those items of income. Thus, for example, dividends are taxed under the provisions of Article 10 (Dividends), and not as business profits, except as provided in paragraph 6 of Article 10.

ARTICLE 8. SHIPPING AND AIR TRANSPORT

Article 8 of the proposed treaty covers income from the operation of ships and aircraft, and profits from the use or rental of containers, trailers, barges, and related container transport equipment, in international traffic. The rules governing income from the sale of ships, aircraft, and containers are in Article 13 (Gains).

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries providing such reciprocal exemptions.

Under the proposed treaty, profits which are derived by an enterprise of one country from the operation in international traffic of ships or aircraft ("shipping profits") will be exempt from tax by the other country, regardless of the existence of a permanent establishment in the other country. International traffic means any transport by ship or aircraft, except where the transport is solely between places in one of the countries (Article 3(1)(g) (General Definitions)).

As is true of some other existing U.S. treaties, the proposed treaty does not provide protection from source country taxation of income from bareboat leases of ships or aircraft in international traffic to the same extent as the U.S. model treaty, which exempts such income from source country tax as income from the operation of ships or aircraft in international traffic. For example, the model provides for exemption from tax in the source country for a bareboat lessor (such as a financial institution or a leasing company) that does not operate ships or aircraft in international traffic but that leases ships or aircraft for use in international traffic. Under the proposed treaty the exemption for shipping profits does not apply to profits from the rental on a bareboat basis of ships or aircraft. Tax treatment of such tangible personal property rental income is governed instead under the business profits article (Article 7, paragraph 7), and is exempt from tax by the source country unless attributable to a permanent establishment in that country.

The exemption does apply to income derived from the use or rental of containers, trailers for the inland transportation of containers, barges, and other related equipment used in international traffic. The U.S. model provides similar treatment for income derived from the maintenance of containers, trailers, barges, and related equipment. The absence of the term "maintenance" in the proposed treaty is not intended to provide a different result. In addition, the shipping and air transport provisions apply to profits from participation in a pool, joint business, or international operating agency, assuming that the other provisions of the treaty (e.g., the limitation on benefits article (Article 28) or paragraph 1(b) of

Article 4 (Residence), relating to treaty benefits for income of partnerships, trusts, and estates) permit such application.

ARTICLE 9. ASSOCIATED ENTERPRISES

The proposed treaty, like most other U.S. tax treaties, contains an arm's length pricing provision similar to section 482 of the Code which recognizes the right of each country to make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements which would have been made between independent enterprises.

For purposes of the proposed treaty, an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. Enterprises are also related if the same persons participate directly or indirectly in their management, control, or capital.

Paragraph 7 of the proposed protocol states that either country may apply the rules of its national law that permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between related persons with a view to apportioning or allocating such deductions, credits, or allowances in accordance with the general principles described above. The treaty is not to be construed to limit either country in allocating income between persons that are related other than by direct or indirect participation described above, such as by commercial or contractual relationships resulting in controlling influence, so long as such allocation is otherwise in accordance with the general principles described above.

Thus, the proposed treaty and protocol make clear that the United States retains the right to apply its intercompany pricing rules (Code section 482, including, it is understood, the "commensurate with income" standard for pricing transfers of intangibles) and its rules relating to the allocation of deductions (Code sections 861, 862, 863, and 864, and applicable regulations).

When a redetermination of tax liability has been properly made by one country, and the other country agrees to its propriety, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. This "correlative adjustment" clause has no counterpart in the present treaty. Its language differs from the corresponding U.S. model treaty language insofar as the correlative adjustment is only required to the extent that the other country *agrees* with the original adjustment by the first country. In making that adjustment, due regard is to be given to other provisions of the treaty and the competent authorities of the two countries will consult with each other if necessary. For example, under the mutual agreement article (Article 25), a correlative adjustment cannot necessarily be denied on the ground that the time period set by internal law for claiming a refund has expired. To avoid double taxation, the proposed protocol's saving clause retaining full taxing jurisdiction in the country of residence or citizenship will not apply in the case of such adjustments.

ARTICLE 10. DIVIDENDS

In general

The proposed treaty replaces the dividend article of the present treaty with a new article that makes several major changes. First, it lowers the source country tax rate generally on direct investment dividends (i.e., dividends paid to companies resident in the other country that own directly at least 10 percent of the voting shares of the payor) ultimately to 5 percent. Second, while the source country rate on portfolio investment dividends (i.e., those paid to companies owning less than a 10 percent voting share interest in the payor, or to noncorporate residents of the other country) will generally remain 15 percent, the treaty will require Germany to afford those German source dividends further tax relief as long as German residents are entitled to imputation credits on such dividends. Third, the proposed treaty permits exceptions to the foregoing source country rates on dividends from a regulated investment company (RIC), real estate investment trust (REIT), or German investment trust (Kapitalanlagegesellschaft). Fourth, the proposed treaty permits the application of internal law to income from arrangements, including debt obligations, carrying the right to participate in profits but deductible by the payor. Fifth, the proposed treaty permits the imposition of the branch profits tax.

Internal Dividend and Branch Profits Taxation Rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S. source dividends (other than dividends paid by an "80/20 company" described in Code section 861(c)) paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax like a U.S. person at the standard graduated rates, on a net basis.

In addition, a foreign corporation engaged in the conduct of a trade or business in the United States is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business.

U.S. source dividends are generally dividends paid by a U.S. corporation. Also treated as U.S. source dividends for this purpose are portions of certain dividends paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business. The U.S. source portion of such dividend is generally equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to its total gross income. No tax is imposed, however, on a foreign recipient to the extent of such U.S. source portion unless a treaty prevents application of the statutory branch profits tax. The tax imposed on the latter dividends is often referred to as the "second tier" withholding tax.

In general, corporations do not receive deductions for dividends paid under U.S. law. Thus, the withholding and branch taxes often represent imposition of a second level of tax on corporate taxable income. Treaty reductions of these taxes reflect the view that where, for example, the United States already imposes corporate level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source country taxation. Moreover, the 5-percent rate reflects the view that the source country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A REIT is a corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met (Code sec. 857(b)). One of those conditions is the requirement that a REIT distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes. A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. Often, the principal income of a REIT is rentals from real estate holdings.

Because a REIT is taxable as a U.S. corporation, a distribution of earnings is treated as a dividend, rather than income of the same type as the underlying earnings. This is true even though the REIT generally is not taxable at the entity level on the earnings it distributes. Because a REIT cannot be engaged in an active trade or business, its distributions are U.S. source and are thus subject to U.S. withholding tax of 30 percent when paid to foreign owners. Distributions of rental income, for example, are not themselves considered rental income. Like dividends, U.S. source rental income of foreign persons is generally subject to U.S. withholding tax at a statutory rate of 30 percent (unless, in the case of rental income, the recipient elects to have it taxed in the United States on a net basis at the regular income tax rates). Unlike the tax on dividends, however, the withholding tax on rental income is generally not reduced in U.S. income tax treaties.

The Code also generally treats RICs as both corporations and conduits for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Thus, the holder of stock in a RIC may be characterized as a portfolio investor in the stock held by the RIC, regardless of the proportion of the RIC's stock owned by the dividend recipient.

Germany

At present, Germany imposes a 25-percent withholding tax on German source dividends. However, the German tax applies to all German source dividends whether paid to residents or nonresidents. The dividend tax is fully refundable to resident shareholders (persons subject to unlimited tax liability in Germany). The dividend tax paid by nonresident shareholders is refundable, if at all, only to the extent of treaty reductions in the tax.

In addition to the refundable 25-percent withholding tax, Germany provides "integration," or relief from the taxation of corporate earnings at both the corporate and individual shareholder levels, through two other features of its tax treatment of dividends. First, Germany imposes a "split rate" on corporate income; under this system, earnings distributed by German resident companies as dividends are subject to a lower corporate income tax rate than are retained earnings. Currently, the tax rate on retained earnings (or "statutory burden") is 50 percent, and the corporate-level tax on distributed earnings (or "distribution burden") is 36 percent. Second, German resident shareholders receive an imputation credit for the corporate-level distribution burden. The credit is applied against the shareholder's German income tax liability or, if the credit exceeds the liability, the excess is refunded to the shareholder. In the absence of a tax treaty, nonresidents of Germany do not receive the imputation credit. This imputation system was introduced into the German tax laws in 1977.

Under the German tax system, the taxable profits of a branch of a foreign corporation are taxable at a flat rate, rather than under the split rate system. Currently, the flat rate is 46 percent.

Treaty reduction of dividend taxes.—Under the proposed treaty, each country may tax dividends paid by its resident companies, but the rate of tax is limited by the treaty if the beneficial owner of the dividends is a resident of the other country. Paragraph 10 of the proposed protocol provides that a country shall deem the recipient of dividends, interest, or royalties who is a resident of the other country to be the beneficial owner for the purposes of this article (and the interest and royalties articles) if the recipient is the person to which the income is attributable for tax purposes under the laws of the first country. Thus, the protocol makes explicit that internal law of the source country governs in determining beneficial ownership for purposes of the rate reductions.

Source country taxation is generally limited to 5 percent of the gross amount of the dividends if the beneficial owner of the dividends is a company which holds directly at least 10 percent of the voting shares of the payor corporation. The tax is generally limited to 15 percent of the gross amount of the dividends in other cases involving dividends paid to residents of the other country.

The prohibition on source country tax in excess of 5 percent on direct investment dividends does not apply to a dividend from a RIC or REIT, or to a distribution on certificates of a German investment trust. Thus, the proposed treaty allows the United States to impose a 15-percent tax on a U.S. source dividend paid by a RIC to a German company owning 10 percent or more of the voting shares of the RIC. In addition, there is no limitation in the proposed treaty on the tax that may be imposed by the United States on a dividend paid by a REIT to a German resident, if the recipient is either an individual holding a 10 percent or greater interest in the REIT, or a company. Such a dividend would thus be taxable by the United States, assuming no change in present internal law, at the full 30-percent rate.

The limitations on source country taxation of dividends do not affect the taxation of the profits out of which the dividends are paid.

Imputation-related benefit.—The effective rate of German and U.S. tax on dividends paid by a German resident company and beneficially owned by a U.S. resident are reduced further by means of an imputation-related German tax reduction and U.S. credit. This benefit is available as long as Germany's imputation system is in effect for natural persons resident in Germany. The Committee understands that the proposed treaty clause providing German integration-related relief was the first such treaty clause negotiated and signed by Germany. To date, it is understood that Germany has signed but not yet ratified one other similar treaty clause with Switzerland.

Under the German imputation system, German resident shareholders generally receive a "gross-up" in their dividend, and a corresponding equal imputation tax credit, equal to a percentage of the dividend. The credit and gross-up are currently 56.25 percent (9/16, or 36/64) of the dividend, or 36 percent of the grossed up dividend. (For simplicity, use of the terms "dividend" and "grossed up dividend" here ignores the 25-percent withholding mechanism under German law.) The grossed up dividend represents the pre-tax corporate profits distributed to the shareholder.

For example, assume that a German corporation with a single German shareholder earns 100. The statutory burden is 50. Assume that the entire 50 is distributed. This results in a decrease of 14 in the corporate tax burden if the full 14 is also distributed. Assume that this is the case. The shareholder has received a cash dividend of 64 (ignoring withholding taxes). This dividend must be grossed up by 56.25 percent (9/16, or 36/64) in computing the shareholder's taxable income. The gross up here equals 36, or 36/64ths of 64. The shareholder's income associated with the dividend therefore equals 100, or 64 plus 36. (This is also the amount of the corporation's pre-tax income.) Because the amount of the gross-up is also a tax credit to the shareholder, this 100 of shareholder income carries a credit of 36, which equals the corporate tax paid and not previously refunded to the corporation. The income tax imposed on these earnings will thus be whatever tax is imposed on the 100 at the individual level, minus 36. This, in turn, is the same tax that would have been imposed had the 100 been earned directly by the shareholder. The credit, when considered together with the split rate system, alleviates the double taxation of distributed profits earned by German companies.

For practical reasons, the credit is allowed under German law for dividends treated as having been derived from corporate profits on which the payor corporation has not paid the distribution burden, i.e., the lower of the two corporate rates. In such cases, an increased corporation tax will be imposed in the period of distribution to compensate for the amount of the shareholder credit in excess of the corporate tax previously paid.

As described above, under German law, the imputation credit either is applied against a resident shareholder's German income tax liability or, if the credit exceeds such liability, is refunded to the shareholder. Shareholders who have no German tax liability obtain a refund on demand. No imputation credit is allowed by Germany with respect to dividends paid to nonresidents of Germany, however, either by statute or treaty currently in force. Thus, a higher tax burden is imposed on dividends paid to nonresident shareholders than is imposed on dividends paid to German resident shareholders.

For example, assume that a German corporation with a single individual U.S. shareholder earns 100 and fully distributes the earnings. After any necessary adjustments in the corporation tax, the German corporation will have paid a tax of 36 on the earnings. The shareholder has received a cash dividend of 64 (ignoring withholding taxes). Under the present treaty, Germany will withhold a nonrefundable tax of 15 percent, or 9.60. Combined German tax on these earnings is therefore 45.60. Assuming a U.S. tax rate of 28 percent on the individual, the pre-foreign tax credit U.S. liability is 17.92. Less credits, the amount of tax paid to the United States is 8.32. The German (corporate and shareholder) and U.S. income tax imposed on the original 100 of pre-tax corporate earnings will thus total 53.92.

The proposed treaty and protocol reduce, although they do not eliminate, the disparity between the German tax burden imposed on dividends paid to nonresident shareholders and that imposed on dividends paid to German resident shareholders. Under the proposed treaty, U.S. portfolio investors in German resident companies generally will be entitled to a reduction in the 15-percent treaty-reduced German tax equal to an additional 5 percent of gross dividends beneficially owned. For U.S. tax purposes, the recipient is treated as having received a dividend approximately equal to an amount 85 percent of which would equal 90 percent of the gross dividend actually paid. The recipient is further treated as having paid creditable foreign income tax equal to 15 percent of that deemed dividend amount. Arithmetically, the U.S. shareholder receives the same U.S. tax treatment as if he or she had received a refund (and an income gross-up) for a corporate level tax equal to 5.88 percent of the cash dividend, and had in addition paid a withholding tax equal to 15 percent of the grossed up dividend.

For example, assume that a German corporation with a single individual U.S. shareholder earns 100 and fully distributes the earnings. After any necessary adjustments in the corporation tax, the German corporation will have paid a tax of 36 on the earnings. The shareholder has received a cash dividend of 64 (ignoring withholding taxes). Under the proposed treaty, Germany will withhold a nonrefundable tax of 10 percent, or 6.40. Combined German tax on these earnings is therefore 42.40. For U.S. purposes, however, the shareholder will be treated as having received (before tax) approximately 67.76, or 64 grossed up by 5.88 percent (rather than by the 56.25 percent by which a comparable German shareholder's dividend would have been grossed up). Because the amount of the gross-up is also a tax credit to the shareholder, this shareholder income carries a credit of 10.16 (or 6.40 plus 3.76), which is also 15 percent of the grossed up dividend. This credit exceeds the German withholding tax imposed on the dividend, but is less than the 42.40 combined corporate and shareholder level German tax burdens. Assuming a U.S. tax rate of 28 percent on the individual, the pre-foreign tax credit U.S. liability is 18.97. Less credits, the amount of tax paid to the United States is 8.81. The German (corporate and shareholder) and U.S. income tax imposed on the original 100 of pre-tax corporate earnings will thus total 51.21.

This rate is similar to the combined U.S. corporate and U.S. individual tax rates imposed on income earned by a U.S. corporation and distributed to a U.S. shareholder.[11] It is also similar to the rate of German corporate tax on undistributed corporate profits. Finally, it is not dissimilar from the German marginal income tax rate applicable to individuals in the upper German income tax brackets. (Currently the top marginal rate is 53 percent.) Thus, unlike the German investor, a U.S. investor in a German corporation does not get the full benefit of applying domestic individual tax rates to distributed German corporate profits. On the other hand, his German taxes are reduced by the proposed treaty's additional 5 percent benefit more than his U.S. taxes are increased, without reducing the total tax imposed below the levels imposed by Germany on German investors or by the United States on investment income generally of U.S. persons. As compared to the result under the present treaty, the earnings bear $3.20 less German tax, and 49 cents more U.S. tax under the proposed treaty. However, the earnings still bear considerably more tax than if Germany were to allow the U.S. resident, as it does the German resident, a refund of the corporate tax paid on the earnings (whether or not a 15 percent withholding tax were retained by Germany). The upward adjustment to German corporate tax for dividends paid out of low-taxed earnings arguably means that the treaty's mechanism for providing the additional 5 percent benefit to U.S. portfolio investors does not result in U.S. taxpayers receiving credits for foreign taxes not paid.

The United States has income tax treaties with numerous countries the internal tax laws of which provide for some degree of integration of the tax liabilities imposed on domestic corporations and domestic shareholders. Treaties with some of these countries provide no extension of the domestic shareholder imputation benefits to U.S. resident shareholders. By contrast, the U.S. income tax treaties with the United Kingdom and France provide U.S. resident shareholders refunds of the imputation credits provided under the laws of those countries to domestic resident shareholders.

The additional 5 percent benefit provided under the proposed treaty to U.S. portfolio investors in German companies is arithmetically similar to the refund of an imputation credit. However, two aspects of the proposed treaty distinguish it from the French and U.K. treaty refunds. First, the amount of benefit provided under the French and U.K. treaties is greater than that provided under the proposed German treaty. For example, under the French treaty, a U.S. resident who receives a portfolio dividend from a French company is entitled to a refund equal to the French imputation credit (the avoir fiscal) that a French resident would receive on the dividend, less a withholding tax of 15 percent of the sum of the cash dividend plus the refund. Currently, the avoir fiscal for a

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[11] For example, if a U.S. corporation earns $100, pays tax of $34, and distributes the rest to an individual, the individual receives taxable income of $66, on which the tax due, at the 28 percent rate, is $18.48. Total U.S. income tax burden on the $100 of pre-tax earnings is therefore $52.48.

French resident amounts to 50 percent of the cash dividend. Under the U.K. treaty, a U.S. resident who receives a portfolio dividend from a U.K. company is entitled to a refund equal to the British imputation credit (the rate of which corresponds to the rate at which the Advance Corporation Tax, or ACT, is imposed), less a withholding tax of 15 percent of the sum of the cash dividend plus the refund. Currently, the British shareholder credit for a British resident amounts to 25/75ths of the dividend paid. A U.S. company that receives a direct dividend from a U.K. company is entitled to a refund equal to half of a British individual's imputation credit less a withholding tax of 5 percent of the sum of the cash dividend plus the refund.

Second, the proposed German treaty also differs from the French and U.K. treaties insofar as it is based not on the actual refund or credit that a German shareholder would receive, but rather on a fixed percentage of the cash dividend. However, the substantial German tax burden even on distributed profits appears to ensure that in fact the fixed "further relief" provided for in the German treaty is matched by tax actually collected by Germany at the corporate level.

Definition of dividends.—The proposed treaty provides a definition of dividends that is largely identical to the definition in the OECD model treaty and some U.S. treaties. Like the U.S. model treaty, the proposed treaty generally defines "dividends" as income from shares or other rights which participate in profits and which are not debt claims. The term also includes income from "jouissance" shares or "jouissance" rights, mining shares, founders' shares, or other rights which participate in profits and which are not debt claims. Dividends also include income from other rights that is subjected to the same tax treatment by the country in which the distributing corporation is resident as income from shares. The proposed treaty further specifies that in Germany the term "dividends" also includes income under a sleeping partnership (Stille Gesellschaft), "partiarisches Darlehen," or "Gewinnobligation" as well as distributions on certificates of an investment trust.

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Neither the dividend article nor the interest article is to prevent either country from applying its internal laws to payments arising in that country from arrangements, including debt obligations, carrying the right to participate in profits, that are deductible in determining the profits of the payor. In Germany, the amounts to which this rule may apply include income under a sleeping partnership, "partiarisches Darlehen," "Gewinnobligation," or "jouissance" shares or "jouissance" rights.

The treaty's reduced rates of tax on dividends will not apply if the dividend recipient has a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and the shareholding on which the dividends are paid forms part of the permanent establishment (or fixed base). Dividends paid on shareholdings of a permanent establishment are to be taxed as business profits (Article 7). Dividends paid on shareholdings of a fixed base are to be taxed as income from the performance of independent personal services (Article 14).

The proposed treaty contains a general limitation on the taxation of dividends paid by corporations which are residents of the other country. Under this provision, Germany may not impose any taxes on dividends paid by a U.S. corporation except where the dividends are paid to German residents or are paid on shareholdings forming part of a permanent establishment or fixed base in Germany. Similarly, the United States may not impose any tax on dividends paid by a German corporation except where the dividends are paid to a resident or citizen of the United States or where the dividends are attributable to a permanent establishment or fixed base in the United States.

Branch profits tax.—The proposed treaty would expressly permit the United States to collect the branch profits tax from a German company.

The Code as amended by the 1986 Act imposes branch level taxes on foreign corporations earning income effectively connected with the conduct of a U.S. trade or business. The Code provides that no U.S. treaty shall exempt any foreign corporation from the branch profits tax (or reduce the amount thereof) unless the foreign corporation is a "qualified resident" of the treaty country.

The Code defines a "qualified resident" as any foreign corporation which is a resident of a treaty country if can meet at least one of the following tests. First, any foreign corporation resident in a treaty country is a qualified resident of that country unless 50 percent or more (by value) of the stock of the corporation is owned (directly or indirectly within the meaning of Code section 883(c)(4)) by individuals who are not residents of the treaty country and who are not U.S. citizens or resident aliens, or 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of the treaty country or the United States. Second, a foreign corporation resident in a treaty country is a qualified resident if the stock of the corporation is primarily and regularly traded on an established securities market in the treaty country, or if the corporation is wholly owned (either directly or indirectly) by another foreign corporation which is organized in the treaty country and the stock of which is so traded, or is wholly owned by a U.S. corporation whose stock is primarily and regularly traded on an established securities market in the United States.

The proposed treaty would allow the United States to impose the branch profits tax (as opposed to the branch level interest tax (Code sec. 884(f)) on a German corporation that either has a permanent establishment in the United States, or is subject to tax on a net basis in the United States on income from immovable property or gains from the disposition of real property interests. (The treaty would also allow Germany to impose a branch profits tax on similar items earned by a U.S. corporation, but only under certain circumstances, discussed below, that do not currently exist.) However, the proposed treaty would permit at most a 5 percent branch tax rate, and, in cases where a foreign corporation conducts a trade or business in the United States but not through a permanent establishment, the proposed protocol would completely eliminate the branch profits tax that the Code imposes on such corporation.

The U.S. tax may be imposed only on that portion of the business profits of the German corporation attributable to its U.S. permanent establishment, and that portion of the corporation's real property income and gains, which represents the "dividend equivalent amount" of those profits as that term is defined under the Code as it may be amended from time to time, without changing the general principle thereof. (Currently the dividend equivalent amount of business profits attributable to a permanent establishment generally is the earnings and profits attributable to a U.S. permanent establishment, plus an additional amount representing any decreases in the permanent establishment's "U.S. net equity" and minus an amount representing any increase in the permanent establishment's U.S. net equity.) None of the restrictions on the operation of U.S. or German internal law branch tax provisions apply, however, unless the corporation seeking treaty protection meets the conditions of the proposed treaty's limitation on benefits article (Article 28). As described in the discussion of Article 28 below, the limitation on benefits requirements of the proposed treaty are very similar, but not identical, to the analogous provisions of the branch profits tax provisions of the Code described above.

The proposed treaty would allow Germany to impose its branch profits tax only on that portion of the business profits of a U.S. corporation attributable to its German permanent establishment, and that portion of the corporation's real property income and gains, that is comparable to the amount that would be distributed as a dividend by a locally incorporated subsidiary. Paragraph 9 of the proposed protocol states that the general principle of the "dividend equivalent amount," as used in U.S. law, is also to approximate that portion of the business profits of a foreign corporation attributable to its U.S. permanent establishment, and that portion of the corporation's real property income and gains, that is comparable to the amount that would be distributed as a dividend if such income were earned by a locally incorporated subsidiary.

The proposed treaty does not permit Germany to impose any branch profits tax unless, under German law, a foreign corporation is subject to corporation tax on the income of its German permanent establishment and its German real property income at a rate not more than 5 percentage points greater than the German corporate "distribution burden" (currently 36 percent). The current German tax rate on branches of foreign corporations is 46 percent, or 10 percentage points greater than that on distributed profits of German companies. Thus, no additional German branch tax is permitted under the proposed treaty.

However, assuming that in the future the difference in the two rates became less than 5 percent, Germany would be permitted under the proposed treaty to impose a branch profits tax, but the sum of the branch profits rate and the German corporate distribution burden would be limited to a rate no greater than 5 percentage points in excess of the distribution burden. Thus, if Germany were to reduce its tax on branches of foreign corporations to 40 percent without changing the 36 percent rate on German corporations, Germany would be precluded from imposing a branch profits tax in excess of 1 percent.

ARTICLE 11. INTEREST

Subject to numerous exceptions (such as those for portfolio interest, bank deposit interest, and short term original issue discount), the United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that apply to dividends. U.S. source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that meets the foreign business requirements of Code section 861(c) (e.g., an 80/20 company). Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is also subject to a branch level interest tax, which is the tax it would have paid had a wholly owned domestic corporation paid it the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business. Germany has a 25 percent tax on interest derived in Germany by nonresidents.

The proposed treaty generally provides that interest derived and beneficially owned by a resident of a country may be taxed only by that country. Thus, the proposed treaty generally exempts from the U.S. 30-percent tax on U.S. source interest paid to foreign persons, interest paid to German residents, and exempts from German taxes interest paid to U.S. residents. Thus, also, the proposed treaty exempts German corporations from imposition by the United States of the branch level interest tax. This is confirmed by paragraph 11 of the proposed protocol, which states that the excess of the amount of interest deductible by a U.S. permanent establishment of a German company over the interest actually paid by the permanent establishment is treated as interest derived and beneficially owned by a German resident. These reciprocal exemptions are similar to those provided in the present treaty and in the U.S. model treaty.

The exemptions apply only if the interest is beneficially owned by a resident of one of the countries. Accordingly, they do not apply if the recipient of the interest is a nominee for a nonresident. Paragraph 10 of the proposed protocol provides that a country shall deem the recipient of dividends, interest, or royalties who is a resident of the other country to be the beneficial owner for the purposes of this article (and the dividends and royalties articles) if the recipient is the person to which the income is attributable for tax purposes under the laws of the first country. Thus, the protocol makes explicit that internal law of the source country governs in determining beneficial ownership for purposes of the rate reductions.

In addition, the exemptions will not apply if the recipient has a permanent establishment or fixed base in the source country and the debt claim is effectively connected with the permanent establishment or fixed base. In that event, the interest will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty, as amended by the protocol, addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by holding that the amount of interest for purposes of applying this article will be the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 10 of the proposed treaty.

Subject to an exception added by the proposed treaty, the treaty defines interest as income from debt claims of every kind, whether or not secured and whether or not carrying a right to participate in profits. In particular, it includes income from government securities and from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures. The treaty defines interest to exclude payments from arrangements, including debt obligations, carrying the right to participate in profits that are deductible in determining the profits of the payor. In Germany, the amounts to which this rule may apply include income under a sleeping partnership, "partiarisches Darlehen," "Gewinnobligation," or "jouissance" shares or "jouissance" rights. Penalty charges for late payment are not interest for purposes of the proposed treaty.

The proposed treaty contains a general limitation on the taxation of interest paid by corporations which are residents of the other country. Under this provision, Germany may not impose any taxes on interest paid by a U.S. corporation except where the interest is paid by a permanent establishment of the corporation located in Germany, or out of certain German real property income or gains, or insofar as the interest is paid to German residents or the debt-claim underlying the interest payment forms part of the business property of a permanent establishment or a fixed base situated in Germany. Similarly, the United States may not impose any taxes on interest paid by a German corporation except where the interest is paid by a permanent establishment of the corporation located in the United States, or out of certain U.S. real property income or gains, or insofar as the interest is paid to U.S. residents or the debt-claim underlying the interest payment forms part of the business property of a permanent establishment or a fixed base situated in the United States.

ARTICLE 12. ROYALTIES

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangible property in the United States. Such royalties include motion picture royalties. Germany has a 25 percent tax on royalties derived by nonresidents.

The proposed treaty provides that royalties derived and beneficially owned by a resident of a country generally may be taxed only by that country. Thus, the proposed treaty generally exempts from the U.S. 30-percent tax on U.S. source royalties paid to German residents, and exempts from German tax royalties paid to

U.S. residents. These reciprocal exemptions are similar to those provided in the present treaty and in the U.S. model treaty.

The exemptions apply only if the royalty is beneficially owned by a resident of the other country; they do not apply if the recipient of the royalty is a nominee for a nonresident. Paragraph 10 of the proposed protocol provides that a country shall deem the recipient of dividends, interest, or royalties who is a resident of the other country to be the beneficial owner for the purposes of this article (and the dividends and interest articles) if the recipient is the person to which the income is attributable for tax purposes under the laws of the first country. Thus, the protocol makes explicit that internal law of the source country governs in determining beneficial ownership for purposes of the rate reductions.

In addition, the exemptions will not apply where the recipient is an enterprise with a permanent establishment in the source country or an individual performing personal services in an independent capacity through a fixed base in the source country, and the property giving rise to the royalty forms part of the business property of the permanent establishment or fixed base. In that event, the royalties will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties having an otherwise special relationship) by holding that the amount of royalties for purposes of applying this article will be the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length royalty, for whatever reason, will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess royalties paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 10 of the proposed treaty.

Royalties are defined to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (excluding cinematographic films or works on film, tape, or other means of reproduction for use in radio or television broadcasting); for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience. The term "royalties" also includes gains from the alienation of a right or property described above which are contingent on the productivity, use, or further alienation of such right or property. In addition, paragraph 12 of the proposed protocol provides that where an artiste resident in one country records a performance in the other country, has a copyrightable interest in the recording, and receives consideration for the right to use the recording based on the sale or public playing of such recording, then such consideration shall be governed by this article.

Income from the rental or licensing of cinematographic films and films, tapes, and other means of reproduction for use in radio or television broadcasting is treated as business profit under the proposed treaty (Article 7). Under the present treaty, such income would generally be treated as royalties. Thus, the proposed treaty, unlike the present treaty, would permit one country to tax a resident of the other country on such income if the income was attributable to a permanent establishment in the first country.

ARTICLE 13. GAINS

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he or she is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended ("FIRPTA"), a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations holding U.S. real property.

Under the proposed treaty gains from the disposition of immovable or real property may be taxed in the country where the immovable property is situated. Immovable property for the purposes of this article includes immovable property referred to in article 6 (Income for Immovable (Real) Property), and shares of comparable interests in a company that is, or is treated as, a resident of that other country, the assets of which company consists or consisted wholly or principally of immovable property situated in that other country, and an interest in a partnership, trust, or estate, to the extent that its assets consist of immovable property situated in that other country. Under paragraph 13 of the proposed protocol, the term immovable property situated in the other country includes, when the United States is the other country, a "U.S. real property interest." The proposed treaty thus allows the United States to tax transactions of German residents taxable under FIRPTA.

Gains from the alienation of movable property which forms part of the business property of a permanent establishment which an enterprise of one country has in the other country, or gains from the alienation of movable property pertaining to a fixed base available to a resident of one country in the other country for the purpose of performing independent personal services, including gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such a fixed base, may be taxed in that other country. Paragraph 14 of the proposed protocol clarifies that nothing in this article prevents gains from the alienation by a resident of one country of an interest in a partnership, trust, or estate that has a permanent establishment situated in the other country from being treated as gain under this paragraph of the treaty. Thus, the proposed treaty permits the United States to tax gain from the disposition of an interest in a partnership that has a U.S. permanent establishment, regardless of whether the partnership interest is an interest in U.S. real property.

As described more fully in connection with article 7 (Business Profits), paragraph 4 of the proposed protocol clarifies that, for purposes of the treaty rules stated above, any gain attributable to a permanent establishment (or fixed base) during its existence is taxable in the country where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) has ceased to exist.

Paragraph 5 of the proposed protocol restricts the application of the 1986 Act U.S. rule for taxing the gain on property previously used or held for use in connection with the conduct of a trade or business in the United States, as well as a comparable German law rule. Under the proposed protocol, gain from the alienation of movable property that at any time formed part of the business property of a permanent establishment or fixed base that a resident of one country has or had in the other country may be taxed by the second country only to the extent of the gain that accrued during that time. The tax may be imposed at the time the gain is realized and recognized under the laws of the second country, if it is within ten years of the date on which the property ceased to be part of the business property of the permanent establishment or fixed base (or such shorter period provided by the laws of either country).

Gains from the alienation of ships, aircraft, or containers operated by an enterprise of one country in international traffic, and gains from the sale or exchange of movable property pertaining to the operation of such ships, aircraft, or containers, are taxable only in the country in which the profits of the enterprise deriving such income are taxable according to Article 8 (Shipping and Air Transport), which is generally the country of residence of that enterprise.

Gains from the alienation of any property other than that discussed above will be taxable under the proposed treaty only in the country where the alienator is a resident. This rule does not, however, prevent Germany from imposing its statutory tax on gains from the disposition, by an expatriate resident in the United States, of stock in a German resident company if the U.S. resident was a substantial shareholder in the German company (i.e., if the gain is from alienation of shares forming part of an interest of at least 25 percent in the German company), and disposed of the stock within 10 years of giving up German residence. The gain taxable by Germany under this treaty provision is limited to that resulting from appreciation in the stock while the alienator was a German resident. The treaty also requires the United States to calculate any U.S.-taxable gain on the transaction on the basis of the value of the shares on the date on which the individual has ceased to be a resident of Germany, but does not prevent the United States from including in income any gain accrued up to this date which has not been subject to tax in Germany.

By its terms this provision of the proposed treaty gives the United States and Germany reciprocal taxation rights and obligations. However, it currently applies chiefly to German tax on U.S. residents, because present internal U.S. tax law generally does not impose tax in this situation.

ARTICLE 14. INDEPENDENT PERSONAL SERVICES

Services income in general.—The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7 (Business Profits).) The performance of personal services within the United States can be a trade or business within the United States (Code sec. 864(b)).

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is excluded from U.S. source income, and therefore not taxed by the United States in the absence of a U.S. trade or business, if certain criteria are met. The criteria are: (1) the individual is not in the United States for over 90 days during a taxable year, (2) the compensation does not exceed $3,000, and (3) the services are performed as an employee of or under a contract with a foreign person not engaged in a trade or business in the United States, or they are performed for a foreign office or place of business of a U.S. person.

The U.S. and OECD model treaties and more recent U.S. treaties divide income from personal services into a number of categories, generally including in each case independent personal services, dependent personal services, income from government service, and from pensions, and in some cases also including one or more of the following categories: directors' fees, certain income of entertainers and athletes, income from teaching or research, and income of students and trainees. By contrast, Article X of the present German treaty generally treats independent personal services, dependent personal services, directors' fees, and income of entertainers and athletes without distinction. The proposed treaty replaces that article with articles based on the current models and the more recent treaties.

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty (unlike the present treaty), income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) is treated separately from income from the performance of dependent personal services.

Independent personal services.—Income from the performance of independent personal services in one country by a resident of the other country will be exempt from tax in the country where the services are performed (the source country) unless the individual performing the services has a fixed base regularly available to him in that country for the purpose of performing the services. In that case, the source country can tax only that portion of the individual's income which is attributable to the fixed base.

This article is modified by paragraph 3 of the proposed protocol, under which a resident of one country that performs in the other country concerts, theatrical or artistic performances, or similar shows and revues and that may not be taxed in the performance country under the provisions of Article 17 (Artistes and Athletes) shall not be deemed to have a fixed base in the performance country if his or her presence does not exceed in the aggregate 183 days in the calendar year concerned.

For purposes of this article, independent personal services generally include all independent activities, including but not limited to independent scientific, literary, artistic, educational, or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. Services performed as a partner in a partnership are included where the partner receives the income and bears the losses arising from the services.

The proposed treaty generally provides a broader exemption from source country tax for income from independent personal services than Article X of the present treaty provides for income from labor and personal services. Generally, under the present treaty, an exemption from tax in one country is available to a resident of the other country only if his stay in the first country does not exceed 183 days, the services he performs there are for a resident of the country of which he is a resident, and compensation is not borne by a permanent establishment in the first country. Thus the present treaty does not contain the fixed base limitation found in the proposed treaty.

The exemption from source country tax provided in the proposed treaty for independent personal services income is similar to that contained in the OECD and U.S. model treaties.

It is understood that no change to the model treaty language is necessary to conform the treatment of income derived from independent personal services with Code section 864(c)(6), under which, as described above, any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year. An analogous rule applies to income for a taxable year from independent personal services performed in another year in which a fixed base was available.[12]

ARTICLE 15. DEPENDENT PERSONAL SERVICES

Under the proposed treaty, wages, salaries, and other similar remuneration derived from services performed as an employee in one country (the source country) by a resident of the other country will be taxable only in the country of residence if three requirements are met: (1) the individual is present in the source country for fewer than 184 days during the calendar year concerned; (2) his employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or fixed base of the employer in the source country. This degree of limitation on source country taxation is consistent with the present treaty, as well as the U.S. and OECD models.

The proposed treaty provides that compensation derived from employment as a member of the regular complement of a ship or aircraft operated in international traffic may be taxed only in the employee's country of residence.

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[12] If a treaty country resident receives income for independent activities rendered by that resident, and the activities were performed in the other treaty country in a year during which the resident was present in the second country for more than 183 days (or the resident maintained a fixed base in the second country for more than 183 days), then that income is taxable by the second treaty country, regardless of whether payment for the activities was deferred to years in which the resident had no presence in the second country. *See* Rev. Rul. 86-145, 1986-2 C.B. 297.

This article is modified in some respects for directors' fees (Article 16), entertainers' and athletes' income (Article 17), pensions (Article 18), government service and social security income (Article 19), and income of teachers, researchers, students, and trainees (Article 20). The article is consistent with the corresponding article of the U.S. model treaty.

ARTICLE 16. DIRECTORS' FEES

Under the proposed treaty, directors' fees and similar payments derived by a resident of one country for services rendered in the other country as a member of the board of directors of a company which is a resident of that other country may be taxed in that other country.

This treaty rule for directors' fees differs from that of the U.S. model treaty. The U.S. model generally treats directors' fees as personal service income. This treaty rule also differs from the OECD model treaty, which places no limits on the ability of the country of residence of the company to tax the fees of that company's directors. Under the proposed treaty (as under the U.S. model treaty), the country where the recipient resides continues to have primary taxing jurisdiction over directors' fees except where the services are performed in the country of the company's residence.

ARTICLE 17. ARTISTES AND ATHLETES

Like the U.S. and OECD models, the proposed treaty contains a separate set of rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television "artistes" or musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 14 and 15) and business profits (Article 7) and are intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under this article, one country may tax an entertainer who is a resident of the other country on the income from his personal services as an entertainer in the first country during any year in which the gross receipts derived by him from such activities, including his reimbursed expenses, exceed $20,000 or its Deutsche Mark equivalent. (As discussed below, the competent authorities may under certain circumstances adjust this threshold.) Thus, if a German entertainer maintained no fixed base in the United States and performed (as an independent contractor) for one day of a taxable year in the United States for total compensation of $2,000, the United States could not tax that income. If, however, that entertainer's total compensation were $30,000, the full $30,000 (less appropriate deductions) would be subject to U.S. tax. This provision does not bar the country of residence from also taxing that income (subject to a foreign tax credit. *See* Article 23 (Relief from Double Taxation) below.)

Paragraph 15 of the proposed protocol clarifies that if an entertainer or athlete is not subject to tax in Germany under this article (for example, the person is a U.S. resident who earns less than $20,000 from performing in Germany), Germany may nevertheless withhold tax and need refund the tax only upon application at the end of the calendar year concerned. As discussed below, Article 29 (Refund of Withholding Tax) independently permits each country to impose statutory withholding tax at statutory rates, with the treaty reductions implemented by refund. In addition, under paragraph 6 of Article 29, the competent authorities of the United States and Germany may establish by mutual agreement other procedures for the implementation of the treaty tax reductions. The protocol language regarding German withholding on U.S. residents not subject to tax under the entertainers and athletes article states that it (the protocol) does not affect the competent authorities' ability under paragraph 6 of Article 29 to establish other procedures for the implementation of treaty tax reductions.

The proposed treaty provides that where income in respect of activities exercised by an entertainer or athlete in his capacity as such accrues not to the entertainer or athlete, but to another person, that income may be taxed by the country in which the activities are exercised unless it is established that neither the entertainer or athlete nor persons related to him participate directly or indirectly in the profits of that other person in any manner, including the accrual or receipt of deferred remuneration, bonuses, fees, dividends, partnership income, or other income distributions. (This provision applies notwithstanding the business profits and personal service articles (Articles 7, 14, and 15).) This provision prevents certain performers and athletes from avoiding tax in the country in which they perform by, for example, routing the compensation for their services through a third entity such as a personal holding company or a trust located in a country that would not tax the income.

The foregoing provisions are similar to provisions in the U.S. and OECD model treaty articles dealing with entertainers and athletes. The proposed treaty departs from the models in excluding from the article income derived from activities performed in a country by entertainers or athletes if the visit to that country is substantially supported, directly or indirectly, by public funds of the other country or a political subdivision or a local authority thereof. In that case, the income is taxable only in the entertainer's or athlete's residence country.

ARTICLE 18. PENSIONS, ANNUITIES, ALIMONY, AND CHILD SUPPORT

Under the proposed treaty, pensions and other similar remuneration beneficially derived by a resident of either country in consideration of past employment are subject to tax only in the recipient's country of residence. This rule is subject to the provisions of Article 19 (Government Service; Social Security). Thus it does not apply, for example, in the case of pensions paid to a resident of one country attributable to services performed for government entities of the other, unless the resident of the first country is also a citizen of the first country.

The proposed treaty also provides that annuities may be taxed only in the country of residence of the person who beneficially derives them. (This rule is also subject to the provisions of Article 19 (Government Service; Social Security).) An annuity is defined as a stated sum paid periodically at stated times during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services).

The proposed treaty provides for the treatment of alimony and child support payments, unlike the present treaty. The proposed treaty is similar to the U.S. model to the extent that it provides that alimony is taxable only where the recipient resides and that child support is taxable only in the source country. However, the proposed treaty precludes source country tax on alimony only to the extent it is deductible to the payor. Further, the proposed treaty precludes residence country tax on "non-deductible" alimony.

German internal law differs from U.S. internal law in limiting the alimony deduction by amount, and forbidding any deduction if the recipient is not subject to unlimited tax liability in Germany. The proposed treaty does not require Germany to allow a deduction in excess of the internal law monetary amount limitation. However, paragraph 16 of the proposed protocol provides that in determining the taxable income of a German resident individual, alimony or similar allowances paid to a U.S. resident individual will be deductible in the same amount as if the recipient were subject to unlimited German tax liability.

The term "alimony" as used in this article means periodic payments (made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support) that are taxable to the recipient under the laws of the country of which he or she is a resident.

Child support payments made by a resident of one country to a resident of the other country for the support of a minor child, pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support, may be taxed only in the first country under the proposed treaty.

These treaty rules on alimony and child support are not superseded by the saving clause. Thus under the treaty, a U.S. citizen resident in Germany could not be taxed by the United States on alimony paid by a U.S. resident, despite the tax jurisdiction generally maintained by the United States over its citizens.

ARTICLE 19. GOVERNMENT SERVICE; SOCIAL SECURITY

Article 19 of the proposed treaty carries over without change the government service provisions of Article XI of the present treaty. Thus, under the present and proposed treaties, wages, salaries, and similar compensation and pensions paid by the United States or by its states or political subdivisions to a natural person (other than a German national) are exempt from German tax. Likewise, wages, salaries, and similar compensation and pensions paid by Germany or by its Laender or by municipalities, or pensions paid by a public pension fund thereof to a natural person (other than a U.S. citizen or green card holder) are exempt from U.S. tax. For these purposes, the term "pensions" includes annuities paid to a retired civilian government employee.

Also carried over from Article XI of the present treaty is the rule that pensions, annuities, and other amounts paid by one of the countries or by a juridical person organized under the public laws of that country as compensation for an injury or damage sustained as a result of hostilities or political persecution are exempt from tax by the other state. Thus, for example, the United States may not tax a war reparation payment made by Germany.

Under the model treaties, unlike the present and proposed German treaties, employment compensation paid by a government of one country is exempt from tax by the other country only if the services rendered were in discharge of functions of a governmental nature. If a country or one of its political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature), the provisions of Articles 15 (Dependent Personal Services), 16 (Directors' Fees), 18 (Artistes and Athletes), and 19 (Pensions, Etc.) would apply under the model treaties to remuneration for services rendered in connection with the business. For example, under either the model or the present and proposed treaties, a German government official stationed in the United States is not subject to U.S. income tax. However, a person who is neither a U.S. citizen nor U.S. green card holder, and who works for a German state-owned commercial bank in the United States would be taxable by the United States on his wages under the model treaties, but is not so taxable under the present and proposed treaties.

The proposed treaty, unlike the present treaty, expressly provides for the taxation of social security benefits and other public pensions not arising from government service. While the U.S. model, and many existing U.S. treaties,[13] would permit only the source country to tax such benefits, the proposed treaty permits taxation only by the residence country.

Prior to 1983, U.S. social security benefit payments generally were excluded from gross income by the United States. In 1983, Congress imposed a 30-percent withholding tax on one-half of the amount of social security benefit payments to nonresident aliens, and removed the income exclusion on a portion of social security benefit payments received by U.S. citizens and residents.

In permitting only the residence country to tax social security benefits, the proposed treaty is similar to the U.S. treaties with Canada, Egypt, Italy, and Japan. The residence country is required, however, to treat benefits paid by the social security system of the other country as if they were paid by the residence country's system. Thus, for example, the treaty would give a U.S. resident receiving German benefits the right to the same degree of exclusion of the benefits from income (under Code sec. 86) as would apply if the benefits were paid by the U.S. social security system. In this respect the provision is unique to the proposed treaty, although the Canadian treaty provides for an exclusion from residence country tax for a portion of social security benefits from the other country.

Because the saving clause does not apply to this clause of the treaty, it prevents the United States from taxing U.S. social security payments made to U.S. citizens who are residents of Germany. The only other example of a similar rule involving social security benefits appears in the 1984 U.S.-Italy income tax treaty. That treaty, however, only prohibited U.S. taxation of U.S. social security income of U.S. citizens who were also residents *and* citizens of Italy.

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[13] See the U.S. treaties with Australia, Barbados, Belgium, China, Cyprus, Finland, France, Hungary, Iceland, Jamaica, Korea, New Zealand, the Philippines, and Sri Lanka, and pending treaties such as Denmark, Indonesia, and India.

ARTICLE 20. VISITING PROFESSORS AND TEACHERS; STUDENTS AND TRAINEES

Professors and teachers.—The treatment afforded professors and teachers under the proposed treaty, as amended by the proposed protocol, corresponds generally to the treatment afforded them under the present treaty. There is no corresponding language in the U.S. or OECD models, although other U.S. treaties provide similar benefits.

Under the proposed treaty, a professor or teacher who is a resident of one country and who is present in the other country (the host country) for a period not more than two years for the purposes of carrying out advanced study or research or for teaching at an accredited university, college, school, or other educational institution, or a public research institution or other institution engaged in research for the public benefit, will be exempt from tax in the host country on remuneration for such work. However, this rule does not apply to income from research if the research is undertaken not in the public interest but primarily for the private benefit of a specific person or persons. Under the present treaty, only remuneration for teaching is exempted from host-country tax.

Eligibility for this treaty benefit is contingent on the shortness of time spent in the host country. Thus, paragraph 18 of the proposed protocol provides that if a resident of a country remains in the other, host country for longer than 2 years, the host country may tax the individual under its internal law for the entire period of the visit, unless in a particular case the competent authorities of the two countries agree otherwise. A similar rule applies, for example, under Article 20 of the U.S.-U.K. income tax treaty. Furthermore, under that treaty, rules have been prescribed that prevent an individual from avoiding the tax on income during the initial two years of the visit by exiting the host country briefly before the prescribed period expires, and then returning to continue work there.

The benefits of this rule also will not be available to a person who during the immediately preceding period enjoyed the benefits of the other host country tax reductions, described below, applicable to noncompensatory receipts either from outside the host country or from non-profit organizations or comparable public institutions, or applicable to compensation under $5,000 earned by students and business apprentices.

Students and business apprentices.—A student or business apprentice (including Volontaere and Praktikanten in Germany) who is or was immediately before visiting the host country, a resident of the other country is not taxable in the host country on certain payments he or she receives.

First, if the individual is present in the host country for the purposes of his full-time education or training, the host country may not tax payments, other than compensation for personal services, received for his maintenance, education, or training, if the payments arise from sources, or are remitted from, outside the host country. This provision is excluded from the saving clause. It closely resembles the corresponding provisions of the OECD model treaty and 1981 U.S. model treaty.

Paragraph 17 of the proposed protocol states that payments made out of public funds of one of the treaty countries or by a scholarship organization endowed with such funds shall be considered to arise in full from sources outside the other country. This rule also applies when the payments are made under programs funded jointly by organizations of both countries if more than 50 percent of these funds are provided out of public funds of the first country or by a scholarship organization endowed with such funds. The competent authorities are to consult with each other to identify those scholarship programs whose payments will be treated as arising from sources outside a country under these rules (*cf.* Rev. Rul. 89-67).

Second, the host country may not tax payments, other than compensation for personal services, received as a grant, allowance, or award from a non-profit religious, charitable, scientific, literary, or educational private organization or a comparable public institution. A similar rule is contained in the present treaty, but not the U.S. or OECD models.

Third, a person described under either of the two foregoing rules who is present in the host country for not more than 4 years will not be taxed there on any income from dependent personal services that is not in excess of $5,000 (or its Deutsche Mark equivalent) per year, provided that such services are performed for the purpose of supplementing funds available otherwise for maintenance, education, or training.

This provision does not appear in the present treaty or the model treaties. The $5,000 exemption is intended to be in addition to any other deductions (e.g., personal allowances or the standard deduction) available under the internal laws of the host country. Under current U.S. law, this $5,000 in effect gives the individual the equivalent of the standard deduction applicable to a joint return or the approximate equivalent of the sum of the standard deduction applicable to a single person's return and an additional personal exemption deduction. If the student or business apprentice is not a U.S. resident subject to U.S. tax on his worldwide income, then no standard deduction is available, and his personal exemptions may be limited to one. However, insofar as this treaty provision may apply to an individual who does qualify for the standard deduction and multiple personal exemptions, it will reduce that person's U.S. tax liability further.

Like the benefit for professors and teachers, eligibility for this treaty benefit is contingent on the shortness of time spent in the host country. Thus, if a student or business apprentice remains in the host country for longer than 4 years, the host country may tax the individual's compensation income under its internal law for the entire period of the visit, unless in a particular case the competent authorities of the two countries agree otherwise.

Trainees.—Like the present treaty, the proposed treaty provides a host country tax exemption on compensation remitted from outside the host country and paid to certain trainees on visits of 1 year or less where the compensation does not exceed $10,000 (or its Deutsche Mark equivalent). If either the visit exceeds one year, or the compensation exceeds $10,000, no host country tax reduction is required under this provision. The provision applies to a resident of one of the treaty countries who is an employee of an enterprise of that country or of a non-profit religious, charitable, scientific, literary, or educational private organization or a comparable public institution, and who is temporarily present in the other country (the host country) for a period not more than 1 year to acquire technical, professional, or business experience from any person other than his employer. There is no comparable provision in the U.S. or OECD model treaties.

ARTICLE 21. OTHER INCOME

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or Germany. This article is substantially identical to the corresponding article in the U.S. model treaty.

As a general rule, items of income not otherwise dealt with in the proposed treaty which are derived by residents of either country will be taxable only in the country of residence. This rule, for example, gives the United States the sole right under the treaty to tax income sourced in a third country and paid to a resident of the United States. This article is subject to the saving clause, so U.S. citizens who are German residents would continue to be taxable by the United States on their third-country income, with a foreign tax credit provided for income taxes paid to Germany.

The general rule just stated does not apply to income (other than income from immovable property (Article 6)) if the recipient of the income is a resident of one country and carries on business in the other country through a permanent establishment or a fixed base, and the right or property in respect of which the income is paid is effectively connected with the permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, will apply. The prohibition on taxation by the country other than the residence country does apply, however, to income from immovable property that such country is not given permission to tax under Article 6. An example of such income is income from real property located in a third country.

Paragraph 19 of the proposed protocol provides a clarification of the effect of the exception for income attributed to a permanent establishment or fixed base in the case of a German source dividend earned by (i.e., constituting income attributable to) the U.S. permanent establishment or fixed base of a German resident. In this case, the protocol provides that Germany may tax such a dividend at the reduced rates permitted in the dividends article for dividends paid to U.S. residents. The United States, in turn, may tax the dividend income subject to a credit for the German tax.

ARTICLE 22. CAPITAL

Many countries impose a tax on capital in addition to imposing a tax on income. As a general rule, capital taxes are imposed when the income from the capital would be taxed by the other country imposing the capital tax. The United States does not currently impose a capital tax; however, Germany does. Under Article 2 (Taxes Covered), the German capital tax (Vermoegensteuer) is a covered tax. Article 22 therefore applies to the German capital tax.

Under the proposed treaty, capital may be taxed by the country in which located if it is real property owned by a resident of either country, or if it is personal property forming part of the business property of a permanent establishment or fixed base maintained by a resident of the other country. The owner's country of residence could also tax that property. The right to tax ships, aircraft, containers, and related movable property operated in international traffic belongs to the country which has the right (under Article 8 (Shipping and Air Transport)) to tax income of the enterprise operating or using the property. Thus such capital is generally taxable exclusively by the country of which the person carrying on the enterprise is a resident. All other capital is taxable only in the country of residence.

This article is similar to Article XIV A of the present treaty and to the U.S. and OECD model treaties.

ARTICLE 23. RELIEF FROM DOUBLE TAXATION

In general.—One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on foreign source income only. Moreover, the foreign tax credit provisions contain rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee.

The foreign tax credit limitation is generally computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income, subject to the separate limitation rules discussed above. The limitation is computed separately for certain classifications of income (e.g., passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the averaging of foreign taxes on certain types of traditionally high-taxed foreign source income against the U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on oil and gas extraction income.

Foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit alternative minimum tax (determined without regard to the net operating loss deduction). However, no such limitation will be imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met. The 90 percent alternative minimum tax foreign tax credit limitation, enacted in 1986, overrode contrary provisions of then-existing treaties.

An indirect or "deemed-paid" credit is also provided. A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles that limit the right of a source country to tax income. This article provides further relief where both Germany and the United States would otherwise still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence waives its overriding taxing jurisdiction to the extent that this article applies.

The present treaty provides separate rules for relief from double taxation for the United States and Germany. The present treaty generally provides for relief from double taxation of U.S. residents and citizens by the United States permitting a credit against its tax for the appropriate amount of taxes paid to Germany on income from German sources. The present treaty generally provides for relief from double taxation of German residents by Germany exempting from its tax those items of U.S. source income and U.S. capital that the treaty would permit the United States to tax. However, Germany retains the right to impose tax on certain U.S. source portfolio dividends and on wages, salaries, pensions, and similar compensation paid by a U.S. government to a German citizen. Under the present treaty Germany has generally agreed to allow a credit against its tax for the appropriate amount of taxes paid to the United States on this income. Where a U.S. citizen is a resident of Germany and is hence subject to tax under the internal laws of both countries on his worldwide income, the present treaty provides a rule under which Germany will exempt that person's U.S. source income under the above rules, but will give a foreign tax credit for U.S. tax on all other U.S. source income.

With some modifications, the proposed treaty retains the system of the present treaty. The modifications include broadening the class of U.S. source portfolio dividends for which Germany will grant an exemption, adding to the classes of income for which Germany agrees to give a foreign tax credit, and amending the rule applicable to U.S. citizens resident in Germany.

United States

The proposed treaty contains a provision under which the United States allows a citizen or resident a foreign tax credit for income taxes imposed by Germany. The credit is to be computed in accordance with the provisions of and subject to the limitations of U.S. law (as those provisions and limitations may change from time to time without changing the "general principles hereof"). This provision is similar to that found in many U.S. income tax treaties.

Paragraph 20 of the proposed protocol clarifies the meaning of this language. It states that where the treaty gives Germany the right to tax income, and the income is regarded as U.S. source income under U.S. law, the United States shall grant the credit provided for in the treaty, subject to any U.S. law limiting the foreign tax credit in a way that prevents the crediting of a foreign tax against U.S. source income. The proposed protocol provides that the phrase "general principle hereof" means the avoidance of double taxation by allowing a credit for taxes imposed on items of income arising in Germany, as determined under applicable U.S. source rules, as modified by the treaty. The proposed protocol states that while the details and limitations of the credit pursuant to this definition may change as provisions of U.S. law changes, any such changes must preserve a credit for German taxes paid or accrued with respect to items of German source income.

The proposed treaty also allows the U.S. deemed paid credit to U.S. corporate shareholders of German companies receiving dividends in any taxable year from those companies if the U.S. company owns 10 percent or more of the voting stock of the German company.

The double taxation article provides that German income taxes covered by the treaty (Article 2 (Taxes Covered)) are to be considered income taxes for purposes of the U.S. foreign tax credit. Credits allowed solely by reason of this article, when added to otherwise allowable credits for taxes covered by the treaty, may not in any taxable year exceed that proportion of the U.S. tax on income that German source taxable income bears to total taxable income. Thus, any credit allowed solely by the treaty and not by the Code alone could not be used to offset U.S. tax on income from third-country foreign sources.

Germany

Exemption.—The proposed treaty's general rule for German residents is that if under the treaty the United States may tax an item of U.S. source income, or an item of capital situated within the United States, then Germany will exclude that item from the basis on which German tax is imposed. The proposed treaty allows Germany to employ an "exemption with progression" method with respect to such income. Under the exemption with progression method such income, while exempt from German tax, may be taken into the German tax base for purposes of determining German tax on non-exempt income.

In the case of dividends, the exemption generally applies only to such income from distributions of profits on corporate rights subject to tax under U.S. law as are paid to a German resident company (not including partnerships) by a U.S. resident company of which the German company owns directly at least 10 percent of the voting shares. However, the exemption does not apply to any dividends paid by RICs or other distributions of amounts that have been deducted for U.S. tax purposes in calculating the payor's profits (for example, in the case of a REIT). (This point is clarified in a diplomatic note from Germany to the United States dated November 3, 1989.) Where a German resident owns stock the dividends on which would be exempt from German tax under these rules, the stock is also excluded from the basis on which the capital tax is imposed.

Under paragraph 21 of the proposed protocol, Germany may in some cases override the application of the treaty exemption rule. Under this rule Germany may override the exemption (providing a foreign tax credit instead) as to an item of income or capital in certain cases where the United States and Germany take different views either as to the applicable treaty provision, or as to the taxpayer to whom the income or capital is attributable (unless the difference relates to an attribution under Article 9 (Associated Enterprises). In that case Germany may override the exemption if, as a result of the differing views, the income is subject either to double taxation or double exemption (or inappropriate reduction) from tax. Thus, for example, assume that an item of income is treated by the United States as interest earned by a German resident without a U.S. permanent establishment, and therefore exempt from U.S. tax. Assume also that the same item is treated by Germany as direct dividend income of a German resident or interest income of a U.S. permanent establishment of a German resident, and therefore exempt from German tax without regard to paragraph 21 of the proposed protocol. The protocol permits Germany in this instance to tax the income subject to a foreign tax credit.

Paragraph 21 of the proposed protocol also permits Germany to prospectively override the exemption (and apply instead a foreign tax credit) in order to prevent the exemption of other items of income from taxation in both treaty countries, or other arrangements for the improper use of the treaty. Germany can only override the exemption in such a case after due consultation and subject to the limitations of its internal law, and after notifying the United States through diplomatic channels of the items of income for which it intends to override the exemption.

If Germany notifies the United States of such an override, the United States may, subject to notification through diplomatic channels, characterize such income under the treaty consistently with the characterization of that income by Germany. A notification made under paragraph 21 shall have effect only from the first day of the calendar year following the year in which it was transmitted and any legal prerequisites under the domestic law of the notifying country for giving it effect have been fulfilled.

Credit.—The proposed treaty provides that, subject to the provisions of German tax law regarding credit for foreign tax, U.S. tax on specified items of income earned by a German resident, imposed in accordance with the treaty, may be credited against German tax imposed on those items. For purposes of this rule, such items will be treated as U.S. source income.

There are seven types of income eligible for this treatment under treaty, plus two categories that may be so treated under specified circumstances involving future actions of Germany and the United States. First, the credit rule applies to a dividend paid by a U.S. resident company and not exempt from German tax under the treaty exemption for direct dividends. Second, the credit applies to gains from the disposition of a U.S. real property interest other than the real property itself (e.g., stock in a U.S. real property holding company). Third, the credit applies to directors' fees received by German residents as directors of U.S. companies. Fourth, the credit applies to income of entertainers and athletes to which the separate article dealing with such income (Article 17) applies. Fifth, the credit applies to wages, salaries, and similar compensation and pensions paid by the United States or by its states or political subdivisions to a German national. Sixth, the credit applies to income which would, but for the limitation on benefits article (Article 28) be exempt by treaty from U.S. tax. Seventh, the credit rule also applies to any income to which paragraph 21 of the proposed protocol, described above, applies.

Treatment of U.S. citizens resident in Germany.—The proposed treaty contains special rules for U.S. citizens who are residents of Germany. Under the first rule, Germany will permit the U.S. citizen a credit against German tax imposed on certain income that arises in the United States. This credit is limited to the tax that the citizen would have paid if he were not a U.S. citizen. In addition, the United States will allow the citizen a credit against his U.S. tax for any tax paid to Germany after Germany has allowed the credit for U.S. taxes. The credit comes after the German tax is reduced by the deduction of U.S. taxes. The proposed treaty provides for a limited resourcing of income to give effect to this credit.

Adjustment of German corporate tax on distributed U.S.-source profits.—The relief from double taxation article does not preclude the compensatory imposition of corporation tax in accordance with German internal law. As described above, an imputation credit is allowed to German resident shareholders in German companies. For practical reasons, the credit is allowed under German law for dividends treated as having been derived from corporate profits on which the payor corporation has not paid the distribution burden, i.e., the lower of the two corporate rates (currently 36 percent). In such cases, an increased corporation tax will be imposed in the period of distribution to compensate for the amount of the shareholder credit in excess of the corporate tax previously paid.

If the corporation earned income outside Germany that was taxed outside Germany, it may be argued that the compensatory imposition of corporation tax on the distribution results in double taxation. The foreign income distributed may have been subject to substantial source country tax, but little or no German tax (either because of foreign tax credits or an exemption by treaty, like the exemption in the present and proposed U.S.-Germany treaties). In such a case the compensating increase in German corporation tax upon the distribution will be imposed without regard to the foreign taxes paid, however. For example, assume that the U.S. permanent establishment of a German company earns income fully subject to 34 percent U.S. income tax and 5 percent branch profits tax upon remittance to Germany. If it pays out the earnings as a dividend to German residents, their imputation credits will be gained at the cost of an offsetting additional German corporate tax. Thus, as to the U.S. earnings, the German corporate tax integration system has not eliminated double corporate/shareholder level taxation.

Notwithstanding the potential for double taxation arising from the application of Germany's internal law rules imposing compensatory tax on distributions of U.S. (and other non-German) income, the treaty provides that application of this internal law is not precluded by the relief from double taxation article of the proposed treaty.

ARTICLE 24. NONDISCRIMINATION

The proposed treaty contains a comprehensive nondiscrimination article relating to all taxes of every kind imposed at the national, state, or local level. It is similar to the nondiscrimination article in the U.S. model treaty and to provisions that have been embodied in other recent U.S. income tax treaties. The nondiscrimination article of the proposed treaty differs from the U.S. model in protecting all legal persons deriving their status as such from the United States, not only U.S. citizens. In this regard, the nondiscrimination article of the proposed treaty more closely resembles that of the OECD model treaty.

In general, under the proposed treaty, one country cannot discriminate by imposing other or more burdensome taxes (or requirements connected with taxes) on nationals of the other country than it would impose on its citizens in the same circumstances. This provision applies whether or not the nationals in question are residents of the United States or Germany. By the express terms of the U.S. model, a U.S. citizen who is not a resident of the United States and a German national who is not a resident of the United States would not be deemed to be in the same circumstances. Such language does not appear in the proposed treaty. However, paragraph 22 of the proposed protocol states that the nondiscrimination article does not obligate the United States to subject an individual who is a German national not resident in the United States to the same taxing regime as that applied to a U.S. citizen not resident in the United States.

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprise carrying on the same activities. Consistent with the U.S. and OECD model treaties, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents.

Each country is required (subject to the arm's-length pricing rules of Articles 9(1) (Associated Enterprises), 11(4) (Interest), and 12(4) (Royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The Treasury Department's Technical Explanation indicates that term "other disbursements" is understood to include a reasonable allocation of executive and administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises. For purposes of capital taxes, debts that are owed to residents of the other country are to be deductible to the extent that they would be deductible if owed to a resident of the country of residence of the obligor.

The rule of nondiscrimination also applies to enterprises of one country that are owned in whole or in part by residents of the other country. Enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, will not be subjected in the first country to any taxation or any connected requirement which is other or more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar enterprises.

The saving clause (which allows the country of residence or citizenship to tax notwithstanding certain treaty provisions) does not apply to the nondiscrimination article.

ARTICLE 25. MUTUAL AGREEMENT PROCEDURE

The proposed treaty contains the standard mutual agreement provision, with some differences therefrom, which authorizes the competent authorities of the United States and Germany to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under this article, a resident of one country who considers that the action of one or both of the countries will cause him to pay a tax not in accordance with the treaty may present his case to the competent authority of the country of which he is a resident or citizen. The competent authority will then make a determination as to whether the objection appears justified. If the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, then that competent authority will endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the treaty.

A taxpayer loses the right to present a case to the competent authority after four years from the notification of the assessment giving rise to double taxation or to taxation not in accordance with the treaty. If this requirement is met, however, the provision requires the waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations. The provision, however, does not authorize the imposition of additional taxes after the statute of limitations has run.

The four-year limitation on presentation of competent authority cases is not the preferred U.S. treaty position nor is it in the present German treaty. On the other hand, the OECD model treaty includes a three-year limitation.

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the treaty.

Like the U.S. model treaty, the proposed treaty makes express provision for competent authorities to mutually agree on the allocation of income, deductions, credits, or allowances, the determination of the source of income, the characterization of particular items of income, the common meaning of a term, the application of penalties, fines, and interest under internal law, increases (where appropriate in light economic or monetary developments) in the dollar thresholds in the artistes and athletes article and the students and trainees provisions, and the elimination of double taxation in cases not provided for in the treaty.

Unlike the U.S. model, Article 25 of the proposed treaty makes express provision for competent authorities to mutually agree on the characterization of persons (e.g., whether an entity is a corporation or a partnership), on the treatment of income that is assimilated to income from shares by source country law and treated differently by the other country's law. The Committee understands that this latter provision is intended to provide the competent authorities the ability to deal with possible future changes in the thin capitalization rules of either Germany or the United States.

As discussed above, paragraphs 1 and 6 of the proposed protocol make provision for the competent authorities to agree on the elimination of any double taxation arising from Germany's application to its residents of part 4 of the German "Aussensteuergesetz," the German analogue of subpart F of the Internal Revenue Code, and on common procedures different from those under national law for the allocation to a permanent establishment of expenses deductible in arriving at the business profits attributable thereto.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. This provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the treaty. It also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Germany.

The proposed treaty also gives a taxpayer in a competent authority proceeding the right to present views to the competent authority of either or both of the countries. This is a right that is not spelled out in the model treaties, although it may be granted currently by the U.S. competent authority.

When it seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a Commission consisting of representatives of the competent authorities. This provision is similar to one found in the OECD model treaty, although it is not in the U.S. model or the present German treaty.

The proposed treaty provides that if a disagreement cannot be resolved by the competent authorities, they may agree to submit the disagreement for arbitration. The procedures shall be agreed upon and shall be established between the treaty countries by notes to be exchanged through diplomatic channels. Paragraph 24 of the proposed protocol states that the decision of the arbitration board in a particular case shall be binding on both treaty countries with respect to that case. Paragraph 25 of the proposed protocol states that the treaty countries may release to the board such information as is necessary for carrying out the arbitration procedure, provided that the members of the board are subject to the limitations on disclosure described under the treaty's exchange of information article (Article 26).

Under notes exchanged at the time the treaty was signed, a set of procedures was spelled out for submitting a disagreement to arbitration. The competent authorities may agree to invoke arbitration only after the other competent authority procedures spelled out in the treaty have been fully exhausted, and only if the taxpayer or taxpayers involved consent to be bound by the arbitration decision. The notes provide that the competent authorities will not generally accede to arbitration with respect to matters concerning either the tax policy or the domestic tax law of either treaty country.

The notes describe how an arbitration board will be chosen in each case. Each board will have at least three members. Each competent authority will appoint the same number of members, and these members will agree on the appointment of the other member or members of the board. The other member or members may be from the United States, Germany, or another OECD member country. Further criteria for selecting the other member, or other members, of the arbitration board may be issued by the competent authorities. All board members and their staffs must agree in writing to be bound by applicable confidentiality and disclosure rules.

The decision of a case by an arbitration board must be made on the basis of the treaty, giving due consideration to the domestic laws of the treaty countries and the principles of international law. The board will provide the competent authorities with an explanation of its decision. The decision, although binding with respect to the case at issue, will not have precedential effect. However, it is expected that the decisions ordinarily will be taken into account in subsequent cases involving the same taxpayer or taxpayers, the same issue or issues, and substantially similar facts. The notes state that arbitration board decisions may also be taken into account in other cases where appropriate.

The notes also provide for each treaty country to bear the costs of compensating its appointees, and half of the compensation of the appointees chosen by the arbitration board members. However, the arbitration board is given authority to allocate these costs differently, and each competent authority of a treaty country is given the authority to require the taxpayer or taxpayers to agree to bear that country's share of the costs as a prerequisite for arbitration.

ARTICLE 26. EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to obtain information so that they can properly administer the treaty. The proposed treaty provides for the exchange of information which is necessary to carry out the provisions of the proposed treaty or of the domestic laws of the two countries concerning taxes to which the treaty applies insofar as the taxation under those domestic laws is not contrary to the treaty. The exchange of information is not restricted by Article 1 (Personal Scope). Therefore, third-country residents will be covered. In addition, the United States and Germany may exchange diplomatic notes under which they may exchange information for the purposes of national taxes imposed by either country but not otherwise covered by the treaty.

Any information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the treaty applies. Such persons or authorities can use the information for such purposes only. As indicated in the Technical Explanation, persons involved in the administration of taxes include legislative bodies, such as, for example, the tax-writing committees of Congress and the U.S. General Accounting Office, for use in the performance of their role in overseeing the administration of U.S. tax laws. Exchanged information may be disclosed in public court proceedings or in judicial decisions, unless the competent authority of the country supplying the information raises an objection.

Paragraph 26 of the proposed protocol states that Germany shall under this article exchange information with or without request to the extent provided for in the law of December 19, 1985 (EG-Amtsahilfegesetz) as amended from time to time without changing the law's general principle, namely, that Germany will exchange information.

The proposed treaty contains limitations on the obligations of the countries to supply information. A country is not required to carry out administrative measures at variance with the law and administrative practice of either country, or to supply information which is not obtainable under the laws or in the normal course of the administration of either country, or to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Upon an appropriate request for information, the requested country is to obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. A requested country is to use its subpoena or summons powers or any other powers that it has under its own laws to collect information requested by the other country. It is intended that the requested country may use those powers even if the requesting country could not under its own laws. Thus, it is not intended that the provision be strictly reciprocal. For example, once the Internal Revenue Service has referred a case to the Justice Department for possible criminal prosecution, the U.S. investigators can no longer use an administrative summons to obtain information. If, however, Germany could still use administrative processes to obtain requested information, it would be expected to do so even though the United States could not. The United States could not, however, tell Germany which of its procedures to use.

Where specifically requested by the competent authority of one country, the competent authority of the other country shall, if possible, provide the information in the form requested. Specifically, the competent authority of the second country will provide depositions of witnesses and copies of unedited documents (including books, papers, statements, accounts, and writings) to the extent that they can be obtained under the laws and practices of the second country in the enforcement of its own tax laws.

The proposed treaty further provides that the countries are to endeavor to collect such tax on behalf of the other country as may be necessary to ensure that benefits of the treaty are not going to persons not entitled to those benefits. This provision is carried over from the present treaty with minor modifications. It is also similar to the corresponding provision of the U.S. model treaty.

As is true of the U.S. model treaty, the collection provision does not impose on either treaty country the obligation to carry out administrative measures of a different nature from those used in the collection of its own taxes, or that would be contrary to its sovereignty, security, or public policy.

ARTICLE 27. EXEMPT ORGANIZATIONS

This article carries over from the existing treaty a provision that each country will exempt from tax organizations operated for religious, charitable, scientific, educational, or public purposes and treated as tax-exempt for that reason in the other country, if the organization would, but for the foreign location of its activities and place of organization, be exempt from tax in the first country. The benefits of this article are not contingent upon meeting the requirements of the limitation on benefits article. Paragraph 27 of the proposed protocol states that the competent authorities will develop procedures for implementing this article.

ARTICLE 28. LIMITATION ON BENEFITS

The proposed treaty contains a provision, not found in the present German treaty, intended to limit indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in the United States or Germany.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Germany as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. This use is known as "treaty shopping" and refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the countries which entity, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to reduce the income base of the treaty country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions (i.e., it may be possible to reduce or eliminate taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed new anti-treaty shopping article provides that a person other than an individual (for example, a corporation, partnership, trust, or other business organization) is not entitled to the benefits of the treaty unless it satisfies an ownership/"base erosion" test, a public company test, or an active business test, or unless it is itself one of the treaty countries or a political subdivision or local authority thereof, or else is a not-for-profit, tax exempt organization that also satisfies an ownership test.

Under the ownership/base erosion payment test, more than 50 percent of the beneficial interest (in the case of a company, more than 50 percent of the number of shares of each class of shares) in that entity must be owned directly or indirectly by any combination of one or more individual residents of Germany or the United States, citizens of the United States, certain publicly traded companies (as described in the discussion of the public company test below), the countries themselves, political subdivisions or local authorities of the countries, or certain tax-exempt organizations (as described in the discussion of qualifying organizations below). This rule would, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends or royalties paid to a German company that is controlled by individual residents of a third country. This rule is not as strict as that contained in the U.S. model, which requires 75 percent ownership by residents of the person's country of residence to preserve benefits.

In addition, the ownership/base erosion test is met only if no more than 50 percent of the gross income of the entity is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons or entities other than those just named. This rule is commonly referred to as the "base erosion" rule and is necessary to prevent a corporation, for example, from distributing (including paying, in the form of deductible items such as interest, royalties, service fees, or other amounts) most of its income to persons not entitled to benefits under the treaty. This provision is substantially similar to that in the U.S. model treaty.

Under the public company test, a company that is a resident of Germany or the United States and that has substantial and regular trading in its principal class of stock on a recognized stock exchange is entitled to the benefits of the treaty regardless of where its actual owners reside or the amount or destination of payments it makes. The term "recognized stock exchange" includes the NASDAQ System owned by the National Association of Securities Dealers, Inc.; any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; any German stock exchange on which registered dealings in shares take place; and any other stock exchange agreed upon by the competent authorities of the two countries.

Under the active business test, treaty benefits will be available under the proposed treaty to an entity that is a resident of the United States or Germany, the ownership/interest payment and public company tests notwithstanding, if it is engaged in the active conduct of a trade or business in its residence country, and the income derived from the other country is derived in connection with, or is incidental to, that trade or business. However, this exception does not apply (and benefits are therefore denied) to the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company. This active trade or business rule replaces a more general rule in the U.S. model treaty and some other U.S. income tax treaties that preserves benefits if an entity is not used "for a principal purpose of obtaining benefits" under a treaty.

A Memorandum of Understanding was exchanged by the United States and Germany on the same day the proposed treaty was signed, elaborating on this standard and another aspect of the article discussed below. The memorandum provides several examples of situations in which the good business purpose test would be considered to be met and examples where it would not be met. Under one example, the Memorandum of Understanding states that U.S. source interest income on short-term investments of earnings, retained as working capital, of an active German business carried on by a German company, is incidental to the German business and therefore eligible for treaty benefits on that basis. As another example, the Memorandum of Understanding states that if a third-country resident establishes a German company for the purpose of acquiring a large U.S. manufacturing company, and the German company's only other activity is the operation of a small retailing outlet which sells products manufactured by the U.S. company, dividends from the U.S. company would not be entitled to benefits. In this case, despite an arguable business connection between the U.S. and German businesses, the active German business is not substantial in relation to the business of the U.S. subsidiary.

An entity will also be entitled to benefits under the proposed treaty if it is a not-for-profit organization that, by virtue of that status, is generally exempt from income taxation in its treaty country of residence, provided that more than half the beneficiaries, members, or participants, if any, in the organization are entitled to the benefits of the treaty. Paragraph 28 of the proposed protocol elaborates on this provision. The organizations described are said to include, but not be limited to, pension funds, pension trusts, private foundations, trade unions, trade associations, and similar organizations. In all events, a pension fund, pension trust, or similar entity organized for purposes of providing retirement, disability, or other employment benefits that is organized under the laws of a treaty country will be entitled to treaty benefits if the sponsor of the entity is itself entitled to treaty benefits.

Finally, the treaty provides a "safety-valve" for a treaty country resident that has not established that it meets one of the other more objective tests, but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the treaty. Under this provision, such a person may be granted treaty benefits if the competent authority of the source country so determines. It is expected as explained in the Memorandum of Understanding, that all relevant facts and circumstances will be taken into account by a competent authority under this provision, including: the existence of a clear business purpose for the structure and location of the income earning entity in question; the conduct of an active trade or business (as opposed to a mere investment activity) by the entity; and a valid business nexus between that entity and activity giving rise to the income. They are also to consider whether and to what extent a substantial headquarters operation conducted in a treaty country by employees of a resident of that country contribute to such valid business nexus, and should not, therefore, be treated merely as the "making and managing [of] investments" within the meaning of the good purpose test. The discretionary authority under this provision is intended to be exercised with particular cognizance of the developments in, and objectives of, international economic integration, such as that between the member countries of the European Communities and between the United States and Canada.

The provision is similar to a portion of the qualified resident definition under the Code branch tax rules, under which the Secretary of the Treasury may, in his sole discretion, treat a foreign corporation as being a qualified resident of a foreign country if the corporation establishes to the satisfaction of the Secretary that it meets such requirements as the Secretary may establish to ensure that individuals who are not residents of the foreign country do not use the treaty between the foreign country and the United States in a manner inconsistent with the purposes of the Code rule.

The proposed treaty contains a rule not found in the U.S. model or in most recent U.S. income tax treaties providing that the competent authorities will consult together with a view to developing a commonly agreed application of this article. They are to exchange such information as is necessary to carry out the provisions to the article and safeguard, in cases envisioned therein, the application of their domestic law. The treaty does not condition the applicability of the limitation on benefits article on consultation or information exchange; in other words, the limitation in the treaty is self-executing (except for the exercise of the discretion of the competent authorities under the safety-valve rule).

It appears that any corporation that would satisfy the limitation on benefits article of the proposed treaty would generally also meet the definition of "qualified resident" for branch profits tax purposes in the Code. For example, a German corporation qualifies for treaty benefits under the protocol if there is substantial and regular trading of its principal class of stock on a recognized stock exchange, while that corporation would not meet the 1986 Act's public company test unless such company's stock were *primarily* traded on an established securities market (or the corporation were wholly owned by another corporation whose stock were primarily so traded). It may be that, for practical purposes, those tests could be interpreted in substantially the same fashion. Also, although it is unlikely, a German corporation that met the active business test might conceivably fail whatever tests the Secretary promulgated under Code section 884(e)(4)(C).

ARTICLE 29. REFUND OF WITHHOLDING TAX

As a matter of internal law, the United States generally implements treaty reductions in taxes subject to withholding by reducing the amounts of tax withheld at the source. An alternative that the United States views as permissible under treaties is the refund of amounts withheld at the statutory rates. The proposed treaty contains express language confirming the validity of the latter method under this treaty. It provides that if a treaty country taxes dividends, interest, royalties, or other items of income by withholding at source, then the right to require withholding at the statutory rate is not affected by the treaty. The treaty requires that the tax be refunded on application to the extent of the treaty reduction, if the application is made within four years from the end of the calendar year in which the income was received. The source country may require an administrative certification by the residence country with respect to the taxpayer's fulfillment of the conditions for unlimited tax liability in that country.

The competent authorities are to implement these provisions by mutual agreement under Article 25 (Mutual Agreement Procedure). They may also establish by mutual agreement other procedures for implementing the treaty tax reductions.

ARTICLE 30. DIPLOMATIC AGENTS AND CONSULAR OFFICERS

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the treaty will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply in full to this article, so that, for example, U.S. diplomats who are considered German residents may generally be protected from German tax.

In addition, a member of a diplomatic mission or consular post of one treaty country located in any other country will be deemed to be a resident of the sending country if, in accordance with international law, he is not liable to tax in the receiving country on income from sources outside that country or capital situated outside that country, and he is taxable by the sending country on his total income, or on capital, on the same basis as are residents of that country. Thus, for example, a U.S. diplomat stationed in

France, and owning stock in a German company, would be eligible for any German and U.S. tax reductions under the proposed treaty on dividends from that stock paid to a U.S. resident owning that stock, assuming the other requirements of the article were met.

The proposed treaty also states that it does not apply to international organizations, to organs or officials thereof, or to persons who are members of a diplomatic mission, consular post, or permanent mission of a third country, if they are present in one of the treaty countries and not liable in either one to the same obligations in respect of taxes on income or on capital as are residents.

ARTICLE 31. BERLIN CLAUSE

The treaty will apply in Land Berlin (i.e., Berlin (West)), unless the German government makes a contrary declaration to the U.S. government within 3 months of the dates of entry into force of the proposed treaty. The present treaty also applies to Land Berlin.

ARTICLE 32. ENTRY INTO FORCE

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country and the instruments of ratification are to be exchanged as soon as possible in Washington. In general, the proposed treaty will enter into force when the instruments of ratification are exchanged, and a general effective date of January 1, 1990 is provided. The present treaty ceases to have effect once the provisions of the proposed treaty take effect. However, several changes from the present treaty rules are phased in over a longer period.

General effective dates.—With respect to taxes withheld at source, and the excise tax on insurance premiums, the proposed treaty will be effective for amounts paid or credited on or after January 1, 1990. With respect to other income taxes, the treaty is to be effective for taxable years and assessment periods beginning on or after January 1, 1990, but excluding any fiscal year commencing before that date. With respect to capital taxes, the treaty is to be effective for tax levied on capital owned on or after January 1, 1990.

Exceptions to general rule.—A taxpayer may elect to be taxed under the present treaty (in its entirety) for the first taxable year or assessment period with respect to which the proposed treaty would otherwise be in effect.

Direct dividends generally will not be immediately entitled to the 5 percent rate provided in Article 10. Such dividends paid or credited before January 1, 1992 may be taxed at rates up to 10 percent.

The U.S. branch tax applies only to dividend equivalent amounts for assessment periods or taxable years beginning on or after January 1, 1991. (For this purpose the dividend equivalent amount is deemed to be paid on the last day of the corporation's fiscal year.) The branch tax is to apply at the 5 percent rate from the beginning. In addition, earnings for prior periods will not be taken into account in computing the tax.

Any German tax exemption that would be applicable under the proposed treaty to dividends paid by a corporation, but for the fact that it is a regulated investment company (RIC), will be applicable to such dividends paid before January 1, 1991, if the RIC was in existence on October 1, 1988.

Certain amounts covered by the articles on interest and dividends, including those treated differently under the proposed treaty than under the present treaty, are subject to a special set of exceptions to the foregoing unless these amounts are earned by a permanent establishment or a fixed base in the source country of a resident of the other country. The present treaty, and not the proposed treaty, applies to interest as that term is used in the present treaty paid or credited before January 1, 1991. This rule applies to interest derived from a "partiarisches Darlehen," or a Gewinnobligation. Thus, amounts that are interest under the present treaty but that may be taxed under the internal law of the source country under the proposed treaty because they participate in profits and are deductible by the payor do not lose their source country tax exemption until 1991.

Income from a partiarisches Darlehen or a Gewinnobligation that will not be taxable in the source country to the full extent of its internal law, and income from a debt obligation treated under the proposed treaty as a dividend, will, if paid or credited on or after January 1, 1991, be eligible for the fully-phased-in proposed treaty rates on dividends.

Income derived under a Stille Gesellschaft, and income derived from jouissance shares or jouissance rights, which amounts may be taxed under the internal law of the source country under the proposed treaty because they participate in profits and are deductible by the payor, may be taxed in the source country at no more than 15 percent if paid or credited before January 1, 1991. Income derived under a Stille Gesellschaft, and income derived from jouissance shares or jouissance rights, which amounts may *not* be taxed under the internal law of the source country under the proposed treaty and must instead be taxed at rates no greater than the dividend rates, will be eligible for the fully-phased-in proposed treaty rates on dividends if paid or credited on or after January 1, 1990.

ARTICLE 33. TERMINATION

The proposed treaty will continue in force indefinitely, but either country may terminate it by giving written notice through diplomatic channels before June 30 of any calendar year beginning after the expiration of the 5-year period from the date of its entry into force. A termination will be effective with respect to income of taxable years or assessment periods beginning (or, in the case of taxation at source or excise taxation of insurance premiums, amounts paid or credited) on or after the first day of January next following the date of termination specified in the notice of termination. (The termination will not be effective for any fiscal year beginning before that date.) The termination will be effective with respect to capital taxes levied on items of capital existing on or after that date.

IX. TEXT OF THE RESOLUTION OF RATIFICATION

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes (the Convention), together with a related protocol, signed at Bonn on August 29, 1989 (Treaty Doc. 101-10), subject to the following understanding:

That in the event that the German Democratic Republic and the Federal Republic of Germany unite under the Government of the Federal Republic of Germany, the Convention will apply, according to its terms, to residents of the area currently comprising the German Democratic Republic, and to income from sources within, and to capital situated in, such area, only at such time as the laws imposing the covered national taxes in the area currently comprising the German Democratic Republic and the laws imposing the covered national taxes in the area currently comprising the Federal Republic of Germany are identical in substance. The preceding sentence shall not affect the application of the Convention to any income or capital to which the Convention would apply absent unification.

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